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Commercial Paper: Some Aspects of Article 3 of the Uniform Commercial Code

By Fairfax Leary, Jr.*

Of all the major articles of the Uniform Commercial Code, perhaps Article 3 makes the fewest changes from prior law. Article 3 replaces in part the Uniform Negotiable Instruments Law. It is necessary to say that Article 3 replaces the N.I.L. in part, because some matters formerly covered by the N.I.L. are now relegated to other articles of the Code, while some matters not covered by the N.I.L. are treated by Article 3 of the Code.

It is not possible in the space allotted to do more than give a brief view of Article 3. Detailed analysis on a topic-by-topic basis must be sought elsewhere. All that this paper can do is to discuss, briefly, the “why and wherefore” of Article 3 and examine a few instances of its application in sufficient detail to give the reader some flavor of the whole, and to allay any fears that the law has been drastically or radically changed.

Reasons for Changing the N.I.L.

At the threshold, the question naturally arises as to why the N.I.L., earliest of the uniform laws, sired by Brewster out of Crawford,¹ to use a horseman’s phrase, needed to be changed at all. As we know, the impetus for that statute came from Judge F. Lyman Brewster of Connecticut when he, as President of the National Conference of State Boards of Commissioners for Pro-

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moting Uniformity of Legislation in the United States, secured the appointment, at the August, 1895, meeting of that body, of a committee to draft an act to make uniform the law concerning negotiable instruments. The Committee hired Mr. J. J. Crawford of the New York bar to serve as principal draftsman. Mr. Crawford's draft was ready for discussion by the Committee about three and a half months later. It was considered at the August, 1896, meeting of the Conference of Commissioners and was recommended for adoption by the states. In the following year it was adopted by four states, including Connecticut, Judge Brewster's home state.

Contrast the more deliberate pace of the drafting of the Uniform Commercial Code. Work was started on Article 3 in the last years of World War II, and the text was first presented for adoption by the states in 1952, some seven years later. During that time it had been subjected to scrutiny in whole or in part in each year by both the Conference of Commissioners on Uniform State Laws and the entire body of the American Law Institute, as well as by a Committee of Advisers and the Council of the Institute. Then, as a result of a detailed study in New York, the Editorial Committee was re-activated and some revisions made. The text of Article 3 as adopted in Kentucky, Massachusetts, and Connecticut is the text of the 1957 edition resulting from a consideration of the New York study and criticism.

The N.I.L. had been adopted throughout the United States, and its territories and possessions, starting in 1897, with Georgia falling in line in 1924 as the last state, and Puerto Rico and the Canal Zone taking the plunge in 1933. The Act has been the law in Kentucky since 1904, or for fifty-five years.

A preliminary inquiry, before the question of whether the N.I.L. should be changed could be answered, is to determine how much uniformity the N.I.L. did achieve. On basic funda-

3 Uniform Commercial Code (1952 draft).
5 Act of October 2, 1959 (S.B. 689). (Hereinafter cited as UCC.)
6 See the table of states and territories which have adopted the Uniform Negotiable Instruments Law in Beutel 1353.
7 Ky. Acts 1894, ch. 102.
mentals, one must answer unequivocally that it accomplished a very great deal. Yet there were many statutory variations in the various adoptions. Kentucky departed from the Commissioners' text in some twenty-one sections, Arizona in fifty-one sections, Pennsylvania in two, and Puerto Rico in only one section. Professor Frederick K. Beutel has noted some seventy-seven instances of divisions of authority in the interpretation of this uniform act, without including variations due to subsequent amendments, statutory differences, or special supplementary statutes.

Candor, however, compels the statement that in most of this rather frighteningly large number of non-uniform situations, the courts were dealing with the unusual or non-recurrent case. Some few of the situations were, however, serious, and some resulted from the very all-inclusive coverage of the N.I.L. But, basically, there was a substantial core of uniformity.

On this record, some modification and revision of the N.I.L. would appear fully justified. When the drafting of Article 3 was begun, the very first problem faced was whether the draftsman should work within the framework of the old N.I.L. and patch up the weak spots, or proceed in a different manner. It soon became apparent that a patchwork job just could not be done.

In the first place, where the seventy-seven divisions of authority existed, language must be changed to secure uniformity. No court would be very apt to change its prior considered decisions if the same language were retained and re-enacted, no matter what the official comments accompanying the uniform act might say. In the second place, certain changes were inevitable from the very concept of an integrated commercial code covering almost all phases of commercial law. In the third place, the great changes in the methods of doing business, occurring during the past sixty years, made obsolete some of the material in the N.I.L., showed the need for revision in some other parts, and pointed to the need of restricting the all-inclusive coverage of the statute in other respects.

Finally, on a careful and objective analysis, it was felt that decided improvements in organization of material could be made by some consolidation and re-arrangement of the subject matter.

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8 See the list of variations by the several states in Beutel 1355.
9 Beutel 89 n. 40.
Arrangement of Material in Article 3

Article 3 was ultimately divided into eight parts, as follows: (1) *Form and Interpretation*, which includes primarily the material usually considered under the topic "formal requisites of a negotiable instrument"; (2) *Transfer and Negotiation*, which covers the types of indorsement and their effects; (3) *Rights of a Holder*, wherein is treated the problem of that central character of negotiable instruments law, the "sniveling holder in due course"; (4) *Liability of Parties*, or the specification of the contracts of maker, drawer, acceptor, and indorser and the warranties of each; (5) *Presentment, Notice of Dishonor and Protest*, a sufficiently self-explanatory heading; (6) *Discharge*, which also includes the effect of certain actions on the liability of accommodation parties. These six are the most important of the eight parts. Part 7 is a single section on the effect of the letter of advice of an international sight draft and part 8, captioned "Miscellaneous," aside from covering drafts in a set, deals with certain matters not covered by the N.I.L.¹⁰

In each part, the various matters covered can be classified under four headings: first, that which is unchanged; second, that which is clarified, including the changing of some decisions in some states; third, instances reflecting a change in policy; and fourth, matters not covered by any section of the N.I.L., where experience indicated the need of statutory treatment.

Actually, Article 3 reduces the 196 sections of the N.I.L. to seventy-nine. Of these, some eleven sections must be eliminated from the comparison because they relate to matters not covered directly by the N.I.L. The remaining sixty-eight sections cover about 885 lines of print as compared with approximately 1,300 lines in the N.I.L.

But, in substance, the job done by Article 3 is a job of tidying

¹⁰ The Reporter for Article 3 was William L. Prosser, Dean of the School of Jurisprudence at The University of California at Berkeley, California. The writer was an Assistant Reporter for matters affecting bank collections. Much thought and time were spent on the article by Professors Karl N. Llewellyn and Soia Mentschikoff, Chief Reporter and Assistant Chief Reporter, respectively, and by the Committee of Advisers, consisting of Professor William E. Britton, University of Illinois; Honorable John T. Loughran, Kingston, New York; Willard B. Luther, Esq., Boston, Massachusetts; Professor Maurice H. Merrill, University of Oklahoma School of Law; Mr. Wilbert Ward, New York City; and Honorable John D. Wickem, Madison, Wisconsin. Much consideration was also given by the editorial board of the Code, by the council and membership of the American Law Institute, and by the Commercial Acts section of the National Conference of Commissioners on Uniform State Laws.
up around the edges, of eliminating matter not properly a part of the law of commercial paper, and of codifying, for the sake of good practice, a few areas left to the common law by the N.I.L.\textsuperscript{11}

**Source Materials for Article 3**

The vast bulk of the material in Article 3 can be quite readily traced to its ancestry in the source materials studied by the reportorial staff of the Code charged with responsibility for Article 3. Basically, these materials consisted of the N.I.L., fifty-odd years of court decisions under that uniform act, the common law before the N.I.L., the British Bills of Exchange Act and the decisions interpreting it, the various law review articles written about both statutes, and, in particular, the celebrated controversy between Judge Brewster and Dean Ames of Harvard,\textsuperscript{12} in which, as so often happens, both were very largely right.

It has always seemed to the writer a bit unfortunate that the approach was so domestic in its scope.\textsuperscript{13} After all, the bill of exchange is, and historically was, a truly international document. In today's world we deal not only with other states of the United States and with other English-speaking countries, but also with European, South American, Asian, and African areas. They, too, have legal systems, some of which were highly advanced when ours was in its infancy. Many of these areas have faced essentially the same problems, and have reached civilized solutions. There have been some attempts at achieving international unity. Efforts to produce a negotiable instruments law that might bring about such unity resulted in the Hague Convention in 1912 and the Geneva Convention in 1930,

\textsuperscript{11} E.g., UCC § 3-119, Other Writings Affecting Instrument; § 3-120, Instruments "Payable Through" Bank; § 3-122, Accrual of Cause of Action; § 3-406, Negligence Contributing to Alteration or Unauthorized Signature; § 3-416, Contract of Guarantor; § 3-510, Evidence of Dishonor and Notice of Dishonor; § 3-602, Effect of Discharge Against Holder in Due Course.


neither of which had much influence on Anglo-American law. While Article 3 was, so to speak, still in the womb of its sponsors, the Inter-American Bar Association at its 1947 meeting in Lima, Peru, and at its 1949 meeting in Detroit, Michigan, was considering what could be done to achieve some Inter-American uniformity between our law and that of our neighbors to the south. Only one or two minor nods towards international unification of the law were, however, made in the Code.\textsuperscript{14}

To many people, however, it may be reassuring to note that Article 3 does not adopt any "strange" foreign approach, but is basically as American in development and concept as the hot dog and Coca-Cola, although it must be admitted that, at the moment, Article 3 does not have quite the same popular appeal.

\textbf{General Exclusions}

Article 3 is entitled "Commercial Paper," and its title reflects a basic policy decision as to the coverage of the article. Eliminated from the scope of Article 3 are all types of instruments qualifying as investment securities under Article 8 of the Code.\textsuperscript{15} Thus, the Code solves an area of considerable difficulty occasioned by the rulings, based upon the reasoning described below, that the N.I.L. applied to corporate bonds.

In section 1, the N.I.L. apparently pre-empted the field of negotiability by providing that "an instrument to be negotiable must conform to the following requirements: \ldots" At first blush,

\textsuperscript{14} Compare UCC § 3-110(1) making negotiable a bill designated on its face as "exchange" or the like, with the civil law rule making the words "bill of exchange" a substitute for words of order.

The civil law custom of using the words "good as avai" to indicate that the signer of the phrase intends to be bound as a surety, can be recognized and given effect under the broader language of UCC §§ 3-415 and 3-416.

UCC § 3-507(4) giving effect to a term in a bill allowing a stated time for re-presentation in the event of any dishonor by non-acceptance of a time draft, or by non-payment of a sight draft, permits parties to stipulate the civil law rule allowing the holder to present again in these circumstances without losing rights against secondary parties. See Report of the Drafting Committee, League of Nations Document No. C.860. M. 151 (1930) II at 141 n. 105.

\textsuperscript{15} UCC § 8-102(a): A 'security' is an instrument which
(i) is issued in bearer or registered form; and
(ii) is of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; and
(iii) is either one of a class or series or by its terms is divisible into a class or series of instruments; and
(iv) evidences a share, participation or other interest in property or in an enterprise or evidence an obligation of the issuer.
this would appear to be an all-inclusive coverage of the field, and to deny the quality of negotiability to any writing not meeting the specified formal requisites, which thus become a bed of Procrustes for all who would pass the test of negotiability. The definition of "instrument" in N.I.L., section 191, as "negotiable instrument" does not aid the situation for two reasons. First, section 191 is prefaced by the usual clause "unless the context otherwise requires," which permits a court to refuse to read the section as "a negotiable instrument to be negotiable must conform . . ." and to construe the section as "any writing to be a negotiable instrument must conform . . .". Second, even if the definition in section 191 were to be brought into section 1, it is still possible to argue that the statute had pre-empted the field and that no other way of achieving the magical qualities of negotiability existed.

Such arguments, together with the requirement that the promise to pay must be unconditional, created great difficulty in the field of the corporate bond issue. The extensive trading in these media of investments made negotiability a necessity. Yet the rather inflexible requirements of the N.I.L. limited the bond draftsman, in section 3(2), to a "statement of the transaction which gives rise to the instrument" and, in section 5, to a provision which "authorizes the sale of collateral securities if the instrument be not paid at maturity" and one which gives the "holder an election to require something to be done in lieu of the payment of money." Decisions such as King Cattle Co. v. Joseph, and its Kentucky companion, Fidelity & Columbia Trust Co. v. Schmidt, however, found that the provisions in the corporate bonds there under consideration were rendered conditional by the reference to the trust indenture or other instrument securing the bonds. On the other hand, cases following Enoch v. Brandon, with almost identical language in the bond, allowed the paper to be classed as negotiable.

In such a state of the law, the cautious statutory draftsman of any act relating to bonds, particularly in the field of municipal bonds, inserted a section providing that the bonds issued thereunder would have all the qualities and incidents of negotiable

16 158 Minn. 481, 198 N.W. 798 (1924).
17 245 Ky. 482, 53 S.W.2d 718 (1932).
18 249 N.Y. 263, 164 N.E. 45 (1928).
instruments. Such terms in the Kentucky statute relating to bearer street-improvement bonds were given effect in *Citizens Trust & Guaranty Co. v. Hays.* Some general statutes were also adopted in other states.

In addition, the rather common practice of trading in overdue and defaulted bonds caused considerable difficulty on the issues of determining rights in overdue paper.

Consequently, it was felt advisable to subject bond issues to a set of rules that would be somewhat different from those applicable to the commercial draft, note, and check, and this is done in Article 8 of the Code.

A second great area which was given separate treatment was the law of bank collections. By section 3-103(2), all of Article 3 is subjected to the terms of Article 4 when an instrument is being collected through banking channels. This was a necessary provision because developments in the field of bank collections, including the use of electronic sorting and computing machines which handle incredibly large numbers of items per minute, required a far different statutory treatment from that accorded the documentary draft or trade acceptance being presented to a business house for payment.

With these major areas eliminated, it was possible to concentrate on the area of commercial paper: the draft, including, of course, the trade acceptance; the note; the certificate of deposit; and certain aspects of the check. Also, since attributes of negotiability were to be accorded in other articles to other paper, Article 3 departed from the all-inclusive nature of the N.I.L. The preamble to section 3-104 states: "Any writing to be a negotiable instrument within this Article must . . . ." The key words, "within this Article," may be the basis on which the courts will continue the common-law development of negotiability for forms of paper not covered by Article 3. It is true that originally the purpose of the drafters was to have a "tight" statute and to

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19167 Ky. 560, 180 S.W. 811 (1915); cf. Ky. Rev. Stat. § 279.180 (1948) (rural electric co-operative societies). Ala. Code Ann. tit. 18, § 22(1940) (electric membership corporations) and the acts creating the various state turnpike commissions and other authorities usually provide that the bonds of such commissions shall "have all of the qualities and incidents of negotiable instruments."

The Hofstader Act in New York is a more general approach. N.Y. Pers. Prop. Law art. 8, §§ 260-262. California, Canal Zone, and Nevada have variously amended N.I.L. § 184 to cover the problem. Beutel 201.

forestall the concept of "negotiability by contract." To this end, as well as for other reasons, section 3-104(1)(b) of the Code provided "that for any writing to be negotiable within Article 3, it must contain an unconditional promise or order to pay a sum certain . . . and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article. . . ." But this limitation applies only to writings that are to be negotiable instruments "within this Article." Section 1-103 of the Code provides that the general principles of law and equity, "including the law merchant," shall continue to apply "unless displaced by the particular provisions of this Act." Hence, it is now possible that, under the Code, certain attributes of negotiability may be given to other types of paper. Official comment #2 to section 2-104 of the Code leans in this direction by saying:

While a writing cannot be made a negotiable instrument within this Article by contract or by conduct, nothing in this section is intended to mean that in a particular case a court may not arrive at a result similar to that of negotiability by finding that the obligor is estopped by conduct from asserting a defense against a bona fide purchaser. . . . But a contract to build a house or employ a workman, or equally a security agreement does not become a negotiable instrument by the mere insertion of a clause agreeing that it shall be one.

The point to be made, however, is that the courts may not feel themselves to be even as restricted as the official comment would indicate in view of the fact that the statutory text refers to what is a negotiable instrument "within this Article."\(^{21}\)

**Some Changes in Formal Requisites**

Article 3 of the Code continues the basic formal requisites of negotiability; i.e., that there must be a signed writing containing an unconditional promise or order to pay a sum certain in money on demand or at a definite time to bearer or to the order of a payee specified with reasonable certainty.

Such a statement is contained in section 3-104(1) coupled

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with the limitation that the instrument must not contain any other promise, order, obligation, or power given by the maker or drawer except as authorized by Article 3. This is followed by separate sections further refining the several elements and permitting most commonly used terms and powers.  

Certainty of Time

To the student of the N.I.L., the above statement of the formal requisites of negotiability has a familiar ring. He will miss the old words, "fixed or determinable future time," and this was intended. The Code, section 3-109(2), in a deliberate policy change, reverses the rule of section 4(3) of the N.I.L. awarding negotiability to instruments payable after events "certain to happen, though the time of happening be uncertain." Typically, this class of instrument was represented by the "post obit" note signed by the impatient nephew desirous of anticipating his inheritance from an elderly maiden aunt. The official comment to the section stresses the fact that no good reason exists for according such an instrument free circulation as a negotiable instrument. The comment also refers to a note payable "one year after the war" or at a similar uncertain date as being likely to be "made under unusual circumstances suggesting good reason for preserving defenses of the maker." One other instance, however, does occur, and that is the "on arrival" draft; i.e., the draft payable "on arrival" of the goods at the town of the payee, or ten days after arrival of goods or the like. Such a draft is specially treated with respect to the bank collection aspects of the problem in Article 4.  

22 UCC § 3-105, When Promise or Order Unconditional; § 3-106, Sum Certain; § 3-107, Money; § 3-108, Payable on Demand; § 3-109, Definite Time, § 3-110, Payable to Order; § 3-111, Payable to Bearer; § 3-112, Terms and Omissions Not Affecting Negotiability.

23 UCC § 4-502. When a draft or the relevant instructions require presentment "on arrival," "when goods arrive" or the like, the collecting bank need not present until in its judgment a reasonable time for arrival of the goods has expired. Refusal to pay or accept because the goods have not arrived is not a dishonor; the bank must notify its transferor of such refusal but need not present the draft again until it is instructed to do so or learns of the arrival of the goods. An early case felt that such an instrument was not negotiable, although there were other grounds for the holding. The Lykus, 36 Fed. 919 (S.D.N.Y. 1888). Mr. Paton, assistant general counsel for the American Bankers Association, expressed the same opinion in 1915. 1 Paton's Digest 157, op. 1019 (1928 ed.), ruling that, in consequence, protest of such a draft was not necessary.
but this seems a bit far fetched, except in time of war. Under the Code, however, a ruling against negotiability seems compelled.

Unconditional Promises or Orders

In section 3-105, a promise or order is deemed conditional (and this, too, is familiar ground), if it states that it is to be paid out of a particular fund or source.\textsuperscript{24} New, however, is the qualification “except as provided in this section.” The exceptions confer negotiability upon two classes of instruments. The first is where the repayment obligation is limited to the entire assets of the issuing partnership, unincorporated association, trust, or estate.\textsuperscript{25} Some cases under the N.I.L. were able to reach this result,\textsuperscript{26} but the problem was a troublesome one elsewhere. The other class is the governmental draft or note which is limited to payment out of a particular fund of the issuing governmental agency or to the proceeds of a particular tax.\textsuperscript{27}

Certain matters, held in some cases to render the instrument conditional, have also been specifically dealt with in the Code. Section 3-105(1)(a) does not permit “implied or constructive conditions” to destroy negotiability.\textsuperscript{28} Paragraph (b) of the same subsection expands the old “statement of the transaction” rule\textsuperscript{29} and provides that a promise or order is not made conditional by the fact that the instrument:

\begin{quote}
[s]tates its consideration, whether performed or promised, or the transaction which gave rise to the instrument, or that the promise or order is made or that the instrument matures in accordance with or “as per” such transaction.
\end{quote}

This language, certainly, makes it clear that trade acceptances are negotiable although bearing the full federal reserve clause:

\textsuperscript{24} See the Uniform Negotiable Instruments Law (herein cited as N.I.L.) § 3, When Promise is Unconditional.
\textsuperscript{25} UCC § 3-105 (h).
\textsuperscript{27} UCC § 3-105 (g).
\textsuperscript{28} Cases have held under the N.I.L. that the recital of an executory promise as consideration raises an implied condition that the instrument need not be paid if the executory promise be not performed, and hence such an instrument is not negotiable. E.g. National Bank in Salem v. Morgan, 132 Or. 515, 284 Pac. 582, 286 Pac. 558 (1930); Ivory v. Lamoreaux, 241 Mich. 226, 217 N.W. 54 (1923); contra, First Nat'l. Bank of Mariana v. Havana Canning Co., 142 Fla. 554, 195 So. 188 (1940); Siegle Cooper Co. v. Chicago Trust & Savings Bank, 131 Ill. 509, 23 N.E. 417 (1890).
\textsuperscript{29} N.I.L. § 3(2).
The obligation of the acceptor hereof arises out of the purchase of goods from the drawer, maturity being in accordance with the original terms of purchase.30

Yet the Code obviously cannot cover all situations and dispense with all litigation. Paragraph (b) of section 1-105(1), says that an instrument is negotiable even though it contains a statement that it matures "as per" a transaction which gave rise to it, and paragraph (c) of the same section allows an instrument to refer to, or state that it arises out of, a separate agreement. Problems of interpretation will still arise as to whether particular language comes within the permitted types, or constitutes language stating that the instrument is subject to or governed by another agreement, which under section 1-105(2) (a), as under the N.I.L., makes the instrument non-negotiable. The problem is similar to the cases involving the Reolo frauds,31 where Maryland on the one side and Pennsylvania and a federal court in Minnesota on the other, took opposite positions as to whether an acceptance was conditional which read "accepted for payment as per Reolo contract for amount and date hereon." The Maryland court felt that the "as per" clause, by reason of the position of the words, put conditions on the promise to pay and denied negotiability. The Pennsylvania court and the federal district court felt otherwise.

The Sum Certain

One or two specifically troublesome matters relating to the "sum certain" have been clarified by section 3-106. Covering familiar ground, the section provides that the sum payable is a sum certain in a note or draft payable in stated installments of principal, or payable with exchange or less exchange, or with costs of collection or an attorney’s fee, or both, upon default.

In addition, this section states that instruments payable with stated different rates of interest before and after default “or a


specified date" will be negotiable, as well as the instrument to be paid "with a stated discount or addition if paid before or after the date fixed for payment." These provisions make it clear that negotiability is not affected by premium charges for anticipating payment dates, by larger charges upon delayed payments, or by the use of a "discount note" allowing the maker, for example, trade discounts if payment is made within thirty days.32

**Acceleration Clauses**

Under the N.I.L., much trouble was caused by various forms of acceleration clauses commonly used by lenders. The business situation is that a lender is willing to make a loan for a specific period of time, if all goes well. If, however, danger looms upon the horizon, the lender wants to be able to pull his money out, or at least have a matured debt. Many and varied are the acceleration clauses devised to meet this situation, running the gamut from automatic acceleration upon default in the payment of an installment of principal or of interest through automatic acceleration in the event of bankruptcy; acceleration at the option of the holder upon the occurrence of events foreshadowing trouble such as non-payment of taxes, the entry of judgments, failure to post additional security, and the like, to acceleration at the option of the holder "when he deems himself insecure." The N.I.L. gave but little help. Section 2(8) expressly recognized automatic acceleration upon default on an installment of principal or of interest due on the note itself, in the section defining the sum certain. In section 4, on time certainty, a note payable "on or before a fixed or determinable future time" was within the statutory language, but it was doubtful if the "on or before" language was intended to cover more than the common law "on or before" note which also gave to the maker the right of prepayment at any time. A note expressed to be payable "on demand" was, of course, always negotiable.

The courts tended to uphold automatic acceleration clauses, were somewhat doubtful about optional clauses based upon the happening of objective events, and looked rather askance at the "deems himself insecure" clause. Many courts denied

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negotiability to such notes, and, indulging in semantics, referred to the clause as permitting acceleration at the "whim or caprice" of the holder.\textsuperscript{33} Obviously, these courts had a feeling that there was something nefarious about a time loan callable at the will of the holder. The reasonable expectations of the borrower, they said, could be defeated by the unfettered power of acceleration. One trouble with this approach is that it apparently assumes that borrowers as a class either do not understand the English language, or else they do not read the notes they sign. If the acceleration clause is in the note, its terms and effect must necessarily be a part of any maker's reasonable expectations. A further trouble was that the proposed cure, a denial of negotiability, did not affect the supposed vice. The acceleration was still good in the case of a non-negotiable note. The only difference was that a maker's defenses against the payee were also good against a holder in due course. Nor did the denial of negotiability serve to stop the use of such clauses. Faced with a choice, the financial interests chose freedom of acceleration rather than negotiability, while making various linguistic changes in the clauses in an effort to succeed on both fronts.

The Code attacks the problem in another way. It provides, in effect, that a note is negotiable although it is subject "to any acceleration." This is done by section 3-109, which is concerned with what constitutes a "definite time." Then, in Article 1 of the Code, applicable generally, section 1-208 provides that a term in any obligation or instrument for the acceleration of payment or performance "at will" or "when he deems himself insecure" or the like gives the power to accelerate only if the holder honestly believes that the prospect of payment or performance has become impaired. The burden of upsetting an acceleration by showing that such honest belief did not exist is placed on the maker of the note.

Thus, the legal issue will be on the very point stressed by the courts, namely, whether the acceleration was proper or not, and the decision will be whether the note is due or not due. Defenses will not be let in against a holder in due course, even on a proper acceleration, as under prior law.

At this point it may not be amiss to ask why we have formal requisites of a negotiable instrument with rules as to sum certain and time certain and so forth. Certainly, the old theories about notes circulating as currency are no longer valid. Bills and notes just do not circulate in that fashion any more. The seller's paper is discounted at his bank and usually rests there, except when forwarded for collection. Credits given between banks are about the only "circulation" of paper today. Financial interests, it is submitted, desire negotiability to separate the obligation to pay money from the performance of the underlying transaction out of which the obligation arises. They can be induced to supply the credit necessary to complete that underlying transaction if their risk is reduced to a credit evaluation risk of the type they are equipped to handle. If, however, in addition to the credit risk, those supplying the money that oils the wheels of progress are made subject to performance risks and quality-of-goods risks, then the money will not be as readily or as cheaply supplied, and the whole pace of the economy will be slowed. Equally, the ability to pay for goods while using them will be denied to many to whom such avenues are now open.

On this line of reasoning, as well as on other grounds, the Code is sound in permitting notes, or drafts, to remain negotiable despite "any acceleration."

This solution to the acceleration problem is not, however, without its amusing side. The post obit note, so carefully outlawed, returns to the fold of negotiable instruments by being drafted as a note payable at, say, one hundred years hence, subject to acceleration, upon the death of the impatient nephew's maiden aunt. So, too, the "on arrival" drafts return to the fold by being drawn payable at a safe date, subject to acceleration if the goods arrive at an earlier date. The possibilities of the carefully drafted acceleration clause are almost limitless, except to the extent that the clauses will be construed as rendering the sum payable uncertain or the promise to pay conditional, or are outlawed on policy grounds as "schemes" or "devices" to evade other rules, for we must not forget that the statutory permission for any acceleration is found in the section amplifying what is meant by "payable at a definite future time," and having no other effect.34

34 See UCC § 3-108(c) and comment 4 thereof.
Miscellaneous

An example of the "tidying-up" process contained in the Uniform Commercial Code is found in the Code's treatment of checks, drafts, or notes drawn payable to "the Estate of Anna Jones, deceased." Under the wording of the N.I.L., this type of situation gave some trouble, since some courts ruled this to be bearer paper. Common sense would seem to dictate that the intent of the person making the instrument so payable was to have it payable to the representative for the time being of the estate, and section 3-110 of the Code so provides in express language. Yet section 9 of the N.I.L. made an instrument payable to bearer if it was payable to a fictitious or non-existent person to the knowledge of the person making it so payable, and, again, if the name of the payee did not purport to be the name of any person. Thus, under the N.I.L., the ruling in favor of bearer paper could not be said to be wholly without statutory support. Departing from semantics, however, the real issue in the cases was, "Who should bear the loss caused by the wrongdoing of the person indorsing the paper in the name of the estate?" Actually, there can be no reliance on the fictitious-bearer character of the paper, and no good reason appears why the purchaser of such paper, or a bank dealing with it, should not ascertain whether or not the person with whom they were dealing, in fact, had power and authority to indorse for the estate.

Another gap in the N.I.L. was filled when the Code introduced a section dealing with the draft "payable through" a named bank, as insurance company drafts are often drawn. Obviously, "payable through" was meant to denote something different than "payable at," which the N.I.L. in several states, including Kentucky, made the equivalent of an order to the bank to pay out of the maker's or drawer's account. Earlier drafts of the Code took the position that the bank named in the "payable through" clause was the sole presenting bank. This position was abandoned when further investigation uncovered the fact that many insurance companies took presentments from banks other than the "payable through" bank. Hence, in

35 McColllum v. Loveless, 185 Ga. 748, 196 S.E. 430 (1938); In re Ziegenhein 187 S.W. 893 (Mo. App. 1916).
36 UCC § 3-120.
37 N.I.L. § 87; cf. UCC § 3-121.
the final draft, section 3-120 provides that the clause simply designates a collecting bank to make presentment.

Section 3-121 continues the N.I.L. wording that a note or an acceptance “payable at” a bank is an order on the bank to pay out of any available funds of the maker or acceptor. This Code section may not be the same in all states, as the studies made in the preparation of the Code indicated that there was a greater divergence of opinion and practice on the effect of a note payable at a bank than on almost any other point. In some instances, there were different practices in the same state. One point of view follows the literal wording, and when a note or acceptance “payable at” is presented, the instrument is paid without more ado if the obligor’s account is in funds. This may be called the “commercial” viewpoint. The other practice is that the words “payable at” merely designate a place for presentment or payment, and no payment should be made without additional authorization from the obligor. The instrument is returned dishonored in some cases unless authorization is received. This might be called the “rural” viewpoint, for it seems to be strongest in rural areas where the farmer desires to control the application of his cash, quite often a scarce commodity. While it is true that an order to pay cash can be cancelled, the rural obligor may not remember to issue the countermand, especially if his habit and custom is founded in the opposite practice. Indeed, in some states having the “order to pay” statutory language in the N.I.L., banking practice was to advise the obligor by telephone and request instructions before paying. The rural fear that the banker’s message might not be received and be answered, plus the banker’s general insistence on a written countermand of a written order to pay, generated in many areas an insurmountable resistance to the “order to pay” language.

The American Law Institute decided that, in this area, the concept of uniformity could be waived and offered alternate sections to the states. In Kentucky, as in Pennsylvania, Mass-

38 UCC § 3-121. Instruments Payable at Bank.

Alternative A:

A note or acceptance which states that it is payable at a bank is the equivalent of a draft drawn on the bank payable when it falls due out of any funds of the maker or acceptor in current accounts or otherwise available for such payment.
achussetts, and Connecticut, the order-to-pay alternative was adopted. Perhaps the Code's recognition of the oral countermand, plus the additional twenty-four hours resulting from the "deferred posting" provisions of Article 4 have done much to allay rural fears. The practice of notifying the obligor and requesting instructions can be continued in rural areas. If the instructions received are not to pay, even if oral, they would be effective as an oral stop order for a far longer period than the time in which the bank must return the instrument.39

**Some Changes in the Law as to Indorsements**

The Code clarifies several areas in that portion of the negotiable instruments law dealing with the effect of indorsements, or the lack of them. The first of these is in the area of the restrictive indorsement.

*Restrictive Indorsements*

Section 36 of the N.I.L., together with the Bank Collection Code of the American Bankers Association,40 classified three factually diverse situations under the label "restrictive indorsement." These were: (1) the indorsement prohibiting further negotiation; (2) the indorsement to a fiduciary; and (3) the indorsement "for deposit" or "for collection" or "pay any bank, banker or trust company"; that is, the indorsement for bank collection. Under sections 37 and 47 of the N.I.L., however, all three types of indorsement had the same effect. The restrictive indorsee had the right to receive payment, to bring any action his indorser could bring, and, except in the case of the indorsement prohibiting further transfer, the power to transfer such rights as he had. Section 47 stated pretty clearly that a restrictive indorsement terminated the negotiability of an instrument.

The result of these sections was that it was difficult, if not

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Alternative B:
A note or acceptance which states that it is payable at a bank is not of itself an order or authorization to the bank to pay it.

39 See UCC § 4-303.
impossible, for a restrictive indorsee to become a holder in due course in his own right, no matter how pure in heart or how great the value paid.\footnote{E.g., Gulbranson-Dickinson Co. v. Hopkins, 170 Wis. 326, 175 N.W. 93 (1919); Werner Piano Co. v. Henderson, 121 Ark. 165, 180 S.W. 495 (1915); Honan v. Nat'l Thrift Corp. of America, 14 Cal. App. 2d 458, 57 P. 2d 967 (1936).} He was limited to the actions his indorser could bring, and could only transfer that privilege to others.\footnote{N.I.L. § 37.} Such a limitation on the indorsee's rights of action would be fine, if we assume that the indorsement was by \textit{A} and read, "Pay to \textit{B} in trust for \textit{A}," since rarely, if ever, did a trustee give value to his \textit{cestui que} trust. The same rule should, perhaps, apply where the indorsement constitutes the indorsee the agent of the indorser. In such cases, limiting the indorsee to the position of the indorser ordinarily does not make for inequitable results. Yet there is nothing inconsistent with an agent advancing funds to a principal, and such an agent should, despite some N.I.L. holdings, be able to attain an independent holder-in-due-course status, at least to the extent of his advances. This is particularly advisable between a depositor principal and an agent collecting bank.

But, followed literally, the words of the N.I.L. apply the "restrictive" indorsement concept to an indorsement from \textit{A} "to \textit{B} as trustee for \textit{C}". Ingenious theories have been advanced in an attempt to confer holder in due course status on \textit{B},\footnote{See \textit{e.g.} Chafee, "Remarks on Restrictive Indorsements," 58 Harv. L. Rev. 1182 (1945).} but it is difficult to see the advantage of \textit{B} being denominated a holder in due course if he is limited to the actions his indorser could bring. Nor is \textit{B} helped if any purchaser from \textit{B} must be no more than a mere assignee.

The Code, however, avoids the problem, after some backing and filling in early drafts. It recognizes the restrictive indorsement idea in section 3-205, covering these four types: (1) conditional; (2) purporting to prohibit further transfer; (3) including words such as "for deposit" or other words signifying a transfer for deposit or collection; or (4) otherwise stating that it is for the benefit either of the indorser or someone else. Section 3-206, however, pertaining to the effect of a restrictive indorsement, provides separate treatment for the several types. There is no counterpart in the Code to the provisions of section 47 of the
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N.I.L. terminating negotiability. On the contrary, subsection (1) of section 3-206 flatly states that no restrictive indorsement prevents further transfer or negotiation. Subsection (2) provides that the restrictive indorsement neither affects nor gives notice to an intermediary or to a collecting bank unless it is the indorsement of the bank’s immediate transferor. Thus, to digress for a moment, the Code does not go as far as the new Cheques Act, 1957, in England where the need of any indorsement is abolished altogether once an instrument is transferred to a bank.\footnote{Cheques Act. 1957. See debates in 204 H.L. Deb. (5th Ser.) 667-692 (1957). Negrah, “Cheques Act. 1957,” 78 J. Inst. Bankers 254 (1957).}

Subsection (3) deals with the conditional indorsement and the indorsement for collection, and requires any transferee, except an intermediary bank, to pay or apply any value given by him consistently with the indorsement. As the section uses the term “transferee,” it does not cover a payor. The section is, however, reinforced by section 3-603(1)(b), providing that any failure to pay in a manner consistent with such an indorsement prevents such non-conforming payment from being a discharge. What actions are consistent with the indorsement depend, of course, upon the type of condition or limitation specified in the indorsement. In the case of the “for collection,” “for deposit,” or the “pay any bank,” form of indorsement, any action in the normal routine of collection would be consistent, since the purpose and terms of the indorsement are to effect collection, or, in the case of an indorsement to a depositary bank, to secure a credit to the indorser’s account.

Section 3-206(4) provides, in the case of the fiduciary indorsement, that the first taker must pay or apply any value given by him for or on the security of the instrument consistently with the terms of the indorsement and that a later holder is not affected by the restrictive indorsement unless he has actual knowledge that the fiduciary has negotiated the instrument for his own benefit or otherwise in breach of trust or duty. Thus, in effect, the Code conforms to the policy of the Uniform Fiduciaries Act in the treatment of the fiduciary indorsement.\footnote{See Uniform Fiduciaries Act § 2.}

Section 3-206 also specifically states that, if he qualifies (including, of course, compliance with the rules as to his payment or application of value as provided in the section), the indorsee
under a restrictive indorsement may be a holder in due course, as may later holders.

Thus, an uncertain and confused situation under the N.I.L. has, it is believed, been rather neatly clarified in accordance with good business practice and needs.

The Once-Bearer-Paper-Always-Bearer-Paper Dogma

Another situation that caused trouble under the N.I.L. is more clearly dealt with under the Code. Under section 40 of the N.I.L., when an instrument payable to bearer was indorsed specially, it was nevertheless subject to further negotiation by delivery. Under section 9(5), an instrument was payable to bearer "when the only or last indorsement is an indorsement in blank."

Thus a note payable to order became payable to bearer when indorsed in blank. Under section 40 of the N.I.L. it apparently remained subject to further negotiation by delivery even though it was later specially indorsed. Also, it was possible to argue by negative inference from section 9(5) that an instrument was no longer payable to bearer when the last indorsement was a special indorsement, since it no longer complied with the literal wording of any of the subdivisions of section 9 on when an instrument is payable to bearer.

The most satisfactory solution seemed to be to limit section 40 to instruments payable to bearer on the face of the paper, and let section 9(5) and the negative inferences therefrom apply to paper originally payable to order. This was thought to conform to the supposed desires of the maker or drawer of paper, which was bearer paper on its face, who wished to make a payment in due course and be discharged without liability for forged indorsements and the like. But this payor protection, in practice, was found to be desired, in fact, almost exclusively in the case of investment securities which are not subject to Article 3 of the Code.

As one of its few changes of policy, the Code reverses the rule of N.I.L., section 40, and provides in section 3-204(1) that "any" instrument which is specially indorsed becomes payable to the order of the special indorsee, whose indorsement is necessary to further transfer. There is no counterpart of section 40 or
of section 9(5). Section 3-204(2) specifically provides that an order instrument indorsed in blank is payable to bearer and is negotiated by delivery until it is specially indorsed, or indorsed for collection. Thus the Code clarifies, by specific treatment, an area which was, to say the least, ambiguous under the N.I.L.

Payee as Holder in Due Course

Under the N.I.L., a serious conflict existed as to whether a payee could ever be a holder in due course. Section 52 of the N.I.L. appeared to require that the instrument be "negotiated" to the payee, and some courts felt that a payee necessarily acquired his title by "issue." The N.I.L. in section 191 defined "issue" as "the first delivery of the instrument, complete in form, to a person who takes it as a holder." N.I.L., section 30, on what constitutes "negotiation," refers to the transfer of the instrument from one person to another in such a manner as to constitute the transferee a holder, and provides "if payable to bearer it is negotiated by delivery; if payable to order it is negotiated by the indorsement of the holder completed by delivery." The definition of a "holder" includes specifically "the payee..., of a bill or note, who is in possession of it." Clearly, a payee, who is a holder, ought therefore to be able to qualify as a holder in due course, if he met the requirements of taking (1) a complete and regular instrument (2) before it was overdue (3) in good faith and for value and (4) without notice of a defect or infirmity or of previous dishonor. That is to say, it would have been clear, had not the statutory text prefaced number 4 with the words "that at the time it was negotiated to him," thus raising the problem of whether there was a difference between taking by "issue" or by "negotiation" in determining who could become a holder in due course. The Code settles the issue by a clear and unequivocal statement in section 3-302(2) that a payee may be a holder in due course, and by eliminating the phrase "that at the time it was negotiated to him he had notice..."

This will change the law in Kentucky, which, apparently, favored the view that a payee could not be a holder in due course.\footnote{See Beutel 88 n. 31, 355-56, 675-90.}
course, while making no change in the law of Pennsylvania, Massachusetts, and Connecticut.

**SOME CHANGES AS TO LIABILITY OF PARTIES**

Several problems as to the extent of the liability of persons whose names appeared on a negotiable instrument have been clarified by the more precise handling of the problem by the Code, and in one or two instances the rules have changed the law.

**The Undelivered, Incomplete Instrument**

Under the N.I.L., it was no defense to the claim of a holder in due course that a completed instrument had not been delivered. Nor, if there had been a delivery of an incompletely instrument, was it a defense to such a claim that completion was not in accordance with what was intended. Put the two together, however, and a so-called “real defense” came into being; that is, the holder in due course did not prevail, conceivably even if the instrument were completed as intended by the non-delivering drawer or maker.

The Code, by section 3-115(2), treats the problem of the liability of the signer of a paper intended to be an instrument, but incomplete in one or more respects, as one of material alteration even if the instrument had not been delivered, and in section 3-407(3) provides that a holder in due course may enforce any incompletely instrument as completed. Of course, the holder in due course cannot recover if the paper was never signed, or if the signed paper was never intended to be an instrument.

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47 Southern Nat'l Life Realty Corp. v. People's Bank, 178 Ky. 80, 198 S.W. 543 (1917); but cf. Thompson v. Peck, 217 Ky. 766, 290 S.W. 722 (1927) and Rider v. Roberts, 255 Ky. 266, 73 S.W. 2d 17, 261 Ky. 317, 87 S.W. 2d 611 (1935).


49 The cases from the various other states are collected in Beutel 675-690.

48 N.I.L. § 16.

49 N.I.L. § 14.


51 Notwithstanding the adoption of the so-called rule of “subjective intent” with respect to the “good faith” of a holder in due course, the writer suggests that a rule of “objective intent” should govern in these situations. What the courts, in fact, will be doing is to balance the interest of an innocent purchaser of a signed completed instrument and the interest of the duped signer who has received no consideration. If a reasonable signer, in all the circumstances of the case, should have realized that the paper was susceptible of completion as an
The signer's lack of specific intent would be a defense, which the signer would have the burden of establishing, just as under section 3-305(2)(c), the signer must establish the defense that there was "such misrepresentation as has induced the party to sign without knowledge or opportunity to learn of its character or essential terms."

The case would be extremely rare where such lack of intent could be established, since most instances involve signatures to printed forms, such as checks, left blank as to payee, date, and amount. One can, however, suppose a signature placed on a piece of paper to be used in the preparation of a facsimile of the signer's signature on, for example, form letters, and then the typing of words of an instrument above the signature. The holder in due course would argue that he was nevertheless entitled to recover since there was a failure to enumerate such a "real defense" as we are now considering in section 3-305(2),52 and since the failure to guard the paper or to put words upon it precluding such a completion was negligence contributing to the unauthorized completion which bars the defense under section 3-406.53 Such a construction would leave section 3-115 without significant meaning, and should not be adopted by a court, if ever a case arises where the signer can persuade the trier of fact that he did not sign the paper intending that it become an instrument. And if some specific listing of this defense

52 The "real" defenses as outlined in UCC § 3-305(2) are:
(a) infancy, to the extent that it is a defense to a simple contract; and
(b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
(c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
(d) discharge in insolvency proceedings; and
(e) any other discharge of which the holder has notice when he takes the instrument.

53 The section was drawn to adopt the rule of Young v. Grote, 4 Bing. 253 (1827), exonerating a drawee who paid an instrument so carelessly drawn that the alteration was not easily detected. It extends the rule to the protection of a holder in due course. It pre-supposes negligence of a type which assists the criminal act of alteration or forgery in such a way as to cast liability upon such person, rather than the second person dealing with the criminal. In view of the official comments, it may be doubted whether the situations calling for the application of this section will go much beyond the prior case law, except in one area. In view of UCC § 4-406(2), the person who is negligent in the examination of his bank statement and report of forgeries may also find himself liable to a holder in due course of subsequently forged checks.
in section 3-305(2) is needed, it could be found in paragraph (b) as an illegality "in the transaction rendering the obligation of the party a nullity."

**Imposter and Fictitious Payees**

The N.I.L. had no provision on the imposter situation. The Code does not go into refinements as did the "face-to-face" or "dominant intent" rules, but states in section 3-405(1)(a), simply, that any indorsement in the name of the payee is effective, if an imposter, by the use of the mails or otherwise has induced the maker or drawer to issue the instrument to him or his confederate in the name of the payee. For the rule to apply, the definition of "issue" in section 3-102(1)(a) must be satisfied, and this means the first delivery of the instrument to a holder or a remitter. Thus, until there has been a delivery to the imposter or his confederate, an indorsement by the named payee is required. After such a delivery, anybody's indorsement of the name of the payee is effective, presumably even that of a thief who stole the instrument from the imposter.

The same technique of requiring an indorsement, but of permitting the indorsement by any person to be effective, is carried over in section 3-405(1)(b) and (c) to the "fictitious payee" situation, the one in which the maker or drawer, or one authorized to sign in his behalf, intends the named payee to have no interest in the instrument. This seems to be a more realistic approach than that of the N.I.L. which used the device of classifying such paper as "bearer" paper. This obviously was not true and could lead to trouble where successive transfers were made.

The Code, to avoid insuperable problems of proof, recognizes the indorsement of the payee's name by any person, but the remaining indorsements must be in order.

54 See the excellent discussion in Abel, "The Imposter Payee, or Rhode Island Was Right," 1940 Wis. L. Rev. 161. The author makes the point that in every imposter situation, there are two people who must deal with the crook—the one who issues the check and the one who takes it for value from the crook. He suggests that the rule of decision should be on a case-by-case balancing of the equities and negligence of the two parties, with the loss falling upon the more careless of the two. The Code appears to place the loss on the first actor in every instance, because in commercial law definite and predictable results are desirable if they are just and correct in the great majority of instances. In the imposter situation, it seems that the first actor is usually the more culpable.

55 N.I.L. § 9(3).
In recognition of modern business practices, and of the statutes or amendments to the N.I.L. adopted by eight states, the Code, in the fictitious payee situation, considers not only the intent of the signer, but also that of an agent or employee of the maker or drawer who supplies the name of the payee. The theory of this is that the actual signer, under modern conditions, does not have any specific intent about most checks or other instruments. He relies on vouchers and other documents prepared by subordinates. In the case of corporations using mechanically-sortable punch card checks and a mechanical check-signer, it seems clear that the controlling intent should be that of the employee who sets up the machine to produce the check by putting the requisite employee record cards into the machine.

The theory is that the risk of loss from the “padded payroll” and like situations should be a risk of the business and not a banking or check-cashing risk, since the signature is valid. This is admittedly a close question on policy, in view of the Anglo-American policy of putting the risk of forged indorsements on the party cashing the check for the forger.

Some problems of interpretation will also arise. It seems clear enough that once we have a “padded payroll” type check, an indorsement in the name of the payee by any person will be effective. But when do we have a “padded payroll” type of check? The key will lie in the interpretation of the words “if an agent or employee of the maker or drawer has supplied him with the name.” Under this phrase, if unauthorized persons having no connection with the business break the locks on the machines in the dead of the night and run off a series of checks, the issuer probably will not be held responsible by reason of section 3-405 of the Code. If an employee, such as a janitor, who has no occasion, in the course of his employment, to handle the payroll cards should succeed in inserting a few cards of employees whose employment had terminated, and in abstract-

56 Georgia, Idaho, Illinois, Louisiana, Missouri, Montana, New Mexico and Wisconsin.
57 This is the general rule, to which the imposter situation, discussed supra note 54, is but an exception. However, other civilized legal systems reach the opposite result where an instrument bears an apparently unbroken chain of indorsements. See Husted, op. cit. supra note 13 as to French, German, Italian, etc. rules.
58 UCC § 3-405(c).
ing the completed checks, would any indorsement in the name of the payee be effective?

On general principles of agency, it would seem that the principal would not be liable in these cases under section 3-405 unless it could be established that the person causing the machine to emit the checks was an agent or employee of the issuer for the purpose of dealing with the preparation of checks or of specifying the names of payees. Under section 3-406, however, the issuer might be precluded from asserting the particular forgery if it could be established that the issuer by its negligence in the operation of the machine is found to have contributed to the unauthorized signature. As is commonly the case, the issuer, by its contract with the bank under which a check-signing machine is used, may have agreed to indemnify the bank against all liability in paying any check bearing the actual imprint of its machine. While the issue here is one, not of the validity of the signature of the issuer, but of the validity of an indorsement admittedly not a valid indorsement at common law, the purpose of the indemnity would be to shift the risk of unauthorized use of the mechanical signer. The indemnity would be broad enough to cover the use of the signer in the padded payroll case but probably not in the imposter situation.⑤9

A practical word of warning. Business concerns in Code states should review their insurance coverage with a view to securing protection against these shifts in risk of loss.

Warranties to a Payor

The problem of the extent of the warranties made upon a sale or transfer of a negotiable instrument is a vexing one, and must of necessity be treated elsewhere.⑥0 But one change in the law is worth mentioning.

⑤9 UCC § 4-406(5) provides:

If under this section a payor bank has a valid defense against a claim of a customer upon or resulting from payment of an item and waives or fails upon request to assert the defense, the bank may not assert against any collecting bank or other prior party presenting or transferring the item a claim based upon the unauthorized signature or alteration giving rise to the customer's claim.


⑥0 See N.I.L. §§ 65, 66; UCC §§ 3-414, 3-417.
At common law, and under the N.I.L., warranties were considered a part of a sale or negotiation, and not, therefore, inherent in a payment transaction. At least the cases seem overwhelmingly to have reached this result.\(^{61}\) The language of N.I.L., section 65, provided for the warranties of a "person negotiating an instrument by delivery or by qualified indorsement." Section 66 states that "every indorser who indorses without qualification warrants to all subsequent holders in due course." A payor did not fit this language, yet payors obviously needed a right of recourse against those presenting instruments not complying with the warranties.

Theories of quasi-contract were not sufficiently definite and certain for the commercial world, nor was it sufficient protection to rely upon clearing house agreement. The result was widespread demand for and acceptance of the "all prior indorsements guaranteed" stamp.\(^{62}\)

Under section 3-417 of the Code, certain warranties will run to a good-faith acceptor or payor as well as to subsequent holders.

One warranty, however, is not made to a payor or to an acceptor and that is a warranty as to the genuineness of the drawer's signature.\(^{63}\) Thus the famous case of Price v. Neal\(^{64}\) is left

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62 The effect of this language was to give the paying bank and all collecting banks a contract action against the party with whom each had dealings, eliminating the equitable defenses available in a quasi-contractual action for money paid under mistake of fact, such as the non-liability of an agent collecting bank which had paid over the proceeds to its principal, etc. The use of the stamp also eliminates any doubt that a restrictive indorsee makes such a warranty. The N.I.L. was not clear on this point. See 2 Paton's Digest 1921 (A.B.A. ed. 1940).

63 UCC § 3-417 (1) (b) establishes a general warranty only that the presenter has no knowledge that the signature of the maker or drawer is "unauthorized" (includes forgery, by definition) and then goes on to state:

- Except that this warranty is not given by a holder in due course acting in good faith
  - (i) to a maker with respect to the maker's own signature; or
  - (ii) to a drawer with respect to the drawer's own signature, whether or not the drawer is also the drawer; or
  - (iii) to an acceptor of a draft if the holder in due course took the draft after acceptance or obtained the acceptance without knowledge that the drawer's signature was unauthorized.

The position of the italicized words "acting in good faith" is, at first blush, puzzling in view of the definition as "honesty in fact" in UCC § 1-201(19), as applied to a warranty of "no knowledge". The comments are not helpful. However, when it is remembered that the warranty is an implied warranty, the words
undisturbed. It is in fact codified, with certain of its exceptions, by section 3-418 on finality of payment. The presenter does make a warranty of no knowledge of an unauthorized signature of the maker or drawer, except that "a holder in due course acting in good faith" does not give this warranty to the maker or drawer himself. Nor is the warranty of no knowledge given by such holder in due course to an acceptor of a draft, if the knowledge of the unauthorized signature was obtained after such holder took an accepted draft or after such holder obtained the acceptance.

SOME CHANGES IN PRESENTMENT, NOTICE AND PROTEST

On just the technical side alone, the Code has done yeoman service to lawyers in gathering together in one place the material on presentment, notice of dishonor, and protest, found scattered through some sixty-odd sections of the N.I.L. In addition, many of the rules were simplified and modernized so as to eliminate as many traps for the unwary as possible. For instance, under the N.I.L., presentment had to be made at a proper place, at a proper time, and in a proper manner. Failure in any element of time, place, or manner would invalidate the presentment with consequent potential discharge of secondary parties. Under the Code, any demand for payment is a proper presentment. Conceivably it could be made between the acts of a play in the lobby of the theatre. It is up to the party to whom presentment is made to require exhibition of the instrument at his office during business hours if he so desires. A refusal to pay stated in the theatre lobby would, however, be a sufficient dishonor.

will probably be construed as applying to any overt conduct or words accompanying a presentment with knowledge which have the effect of lulling the payor and stifling his usual precautions in the examination of signatures, etc., especially in the case of signature by an agent.

64 3 Burr. 1854 (1762).
66 N.I.L. § 72.
68 UCC § 3-504.
69 UCC § 3-505.
Required protest, under the Code, is now limited to the truly international bill, one which on its face appears to be either drawn or payable outside of the states and territories of the United States and the District of Columbia.\textsuperscript{70}

Another beneficial change in the law, made by the Code, is in the rules governing the effect of delay in presenting a check for payment. A check can become "stale" for three purposes: first, as to whether the drawee bank is obliged to pay it;\textsuperscript{71} second, as to whether it is overdue in determining whether a taker is a holder in due course;\textsuperscript{72} and third, as to whether the holder, on dishonor by the drawee, has lost rights against secondary parties.\textsuperscript{73} The periods of time are not the same for each situation.

Under Article 4 of the Code, the bank, in the absence of an agreement to the contrary, is not obliged to pay a check which is more than six months old when presented.\textsuperscript{74}

A demand instrument, at common law and under the N.I.L., became overdue if it was in circulation beyond a "reasonable time" after its date or its issue, whichever was later.\textsuperscript{75} In the case of a check, the period was not certain. A Kentucky case held that a check was overdue after nine months,\textsuperscript{76} and in adjacent Tennessee it has been held not to be overdue although six months old.\textsuperscript{77} Both cases were on the issue of whether holder-in-due-course status could be achieved.

The Code clarifies the issue as to holder-in-due-course status in section 3-304(3)(c), by providing that a check drawn and payable within the states and territories of the United States and

\textsuperscript{70} UCC § 3-501(3).

\textsuperscript{71} See UCC § 4-404, providing that a drawee bank is not under obligation to honor a check that is more than six months old. Statutes of this type were in existence in over one-half of the states prior to the Code. See 1 Paton's Digest 1111 (1940, Supp. 1957) tit. Checks § 20.6, listing 32 non-Code states and the District of Columbia.

\textsuperscript{72} See the cases digested in Beutel 719, applying N.I.L. § 53, as to the "overdue" status of demand instruments "negotiated an unreasonable length of time after its issue."

\textsuperscript{73} See N.I.L. § 186, requiring presentation "within a reasonable time after its issue" and discharging the drawer "to the extent of the loss caused by the delay." See the cases on the problems thus raised digested in Beutel 1291-1304.

\textsuperscript{74} UCC § 4-404.

\textsuperscript{75} N.I.L. §§ 53, 186. The postdated instrument was, when taken after its date, considered as issued upon its date for the purposes of these sections.


\textsuperscript{77} Pan American Petroleum Corp. v. American Nat'l Bank, 165 Tenn. 66, 52 S.W.2d 149 (1932), 17 Minn. L. Rev. 319 (1933).
the District of Columbia is "presumed" to be overdue when it is taken more than thirty days from its issue. Parenthetically, it should be noted that protest is only required where the outside-of-the-United-States character of the instrument appears "on its face" regardless of the actual facts. In the present problem, however, the thirty-day presumption arises from the facts, not the face of the instrument. Thus, if one takes his checkbook to Europe and there issues a check, the thirty-day presumption does not apply even though the check, on its face, appears to have been issued in Philadelphia and to be payable in Philadelphia. In such a case, the Code continues the old familiar "reasonable time" rule.

Where the issue was whether timely presentment had been made for the purpose of holding secondary parties liable, the law under the N.I.L. was very largely the "one day" rule in the case of checks. The cases held that a holder of a check who did not present the check one day after he had received it, if drawn on a bank in the same city, had discharged prior indorsers absolutely, and had discharged the drawer to the extent of the loss occasioned by the delay. If the check was payable in another city, the collection process must be initiated by the day after receipt. These rules, based largely on fear of bank failures, were unreasonable, and were not in accord with the practices of reasonable people.

78 The use of the word "presumed" in this context brings into play the Code definition of the word in UCC § 1-201(31), as meaning that the trier of fact must find that thirty (30) days is a reasonable time "unless and until evidence is introduced which would support a finding of" a different time as reasonable.

A note of caution should be sounded here. Once such evidence is introduced, the local law will apply to determine the effect of the introduction of evidence upon the presumption. Counsel relying upon the 30-day period may still be required to produce affirmative evidence as to its reasonableness if under local law the presumption "disappears" upon the introduction of the necessary quantum of evidence. See Morgan, "Some Observations Concerning Presumptions," 44 Harv. L. Rev. 906 (1931), "Instructing The Jury Upon Presumptions and Burden of Proof," 47 Harv. L. Rev. 59 (1934) passim. Courts should not, however, once evidence is introduced destroying the presumption, revert to the former rules of decision. Such action would violate the entire spirit of the Code provision.

79 UCC § 3-503.
80 E.g. Seager v. Dauphinee, 234 Mass. 96, 187 N.E. 94 (1933). The cases are collected in Beutel 1295-1303.
81 See cases collected in Beutel, loc. cit. supra note 80.
82 This court-made rule did not take proper account of the varying habits of different sections of the community. At certain periods, even large public utility concerns are not able to process all checks received on the day of receipt. Small business concerns often do not bank every day, and individuals frequently carry checks in their pockets for several days. Latent distrust for the banking system has largely vanished. With the advent of Federal Deposit Insurance, a
The Code, by section 3-503(1)(e), provides that, with respect to the liability of secondary parties, presentment is due in the case of demand instruments within a reasonable time after such parties become liable thereon. Subsection (2) of that section contains familiar-sounding language providing that “a reasonable time for presentment is determined by the nature of the instrument, any usage of banking or trade and the facts of the particular case.”

This subsection continues with special rules for an uncertified check which is not a draft drawn by a bank, but which is in fact drawn and payable within “the United States.” Before stating the rules, mention should be made of the fact that in the holder-in-due-course area, the thirty-day presumption applies to all checks. The rules we shall now consider exclude certified checks and bank drafts which presumably should be subject to different rules involving a longer time. Further, this subsection uses only the term “drawn and payable within the United States,” while in the two other areas the wording is “states and territories of the United States and the District of Columbia.” Official comment 3 to this section refers to “uncertified checks drawn and payable within the continental limits of the United States.” The recent admission to statehood of Alaska and Hawaii renders the comment somewhat obsolete and the intended distinction somewhat arbitrary.

33 UCC § 3-504(5) provides simply that: “a reasonable time for a check drawn and payable within the states and territories of the United States and the District of Columbia...”

Note the absence of the words “uncertified” and “which is not a bank draft” found in UCC § 3-503(2). A court could, however, consider certification, etc., as a fact bearing upon the “presumption.” See, however, note 84, infra.

84 Consider the use of such instruments as deposits on bids, earnest money on contracts, all indicating that the payee will retain the instrument for varying periods of time. Case law has recognized this difference. See, e.g. National City Co. of N.Y. v. Mayor and Council of City of Athens, 38 Ga. App. 491, 144 S.E. 836 (1928) (sixty days’ holding of cashier’s check accompanying bid for bonds of city not unreasonable where presented promptly upon fulfillment of conditions of the bid).

The situations justifying the longer holding of such checks do not disclose any policy to be preserved by allowing trafficking in such items. Hence the omission of the exception in the holder-in-due-course area.

85 Taken literally, the “presumption” will apply to a check drawn in Alaska or Hawaii for presentment in New York, but not to a check drawn in the Virgin Islands or Puerto Rico for presentment in Miami, Florida. The use of the word
The rules adopted are again stated in terms of a “presumed” reasonable time of thirty days after date or issue, whichever is later, in the case of the drawer, and seven days after the date of the indorsement in the case of an indorser.86

Just why the Puerto Rican indorser of a check payable in New York should remain liable for longer than seven days while the Hawaiian or Alaskan or Californian is not, is not altogether clear, and since the seven-day period is only a “presumed” reasonable time, decision could well go the other way. The definition of “presumed” in section 1-201(31) reads:

“Presumption” or “presumed” means that the trier of fact must find the existence of the fact presumed unless and until evidence is introduced which would support a finding of its non-existence.

Thus, introduction of evidence of the ordinary mail time between an outlying Hawaiian island and the New York bank should justify extending the time in such a case.87

CONCLUSION

It is not possible within the limits of the space allotted to this article to do more than outline some of the changes made and to try and do this in such a way as may give some flavor of the whole and an insight into the factors considered in making the change. It is not contended, however, that Article 3 of the Code will produce a complete absence of litigation in the law of commercial paper or result in complete uniformity among all fifty states, should it ever secure complete adoption. Article 3 does, however, modernize and consolidate the statute, attempt to pro-

86 UCC § 3-503(2) (a) and (b). Of course, a problem of proof will arise as to the date of indorsement, as indorsements, except machine indorsements in course of bank collections, are seldom dated. But indorsement obviously means indorsement effectual to transfer rights, and, therefore, requires delivery, of which evidence is more readily available in the usual case.

87 In all such cases, careful attention should be given to the words “or to initiate bank collection if there is no delay in the collection.” (Emphasis added). Thus, the time limits are those in which the item should be deposited in the holder’s bank, which presumably is a local one.

Also, the use of jet planes to carry the mails should make the distinctions rather meaningless. The thrust of the legislation is to extend the strict judge-made “one-day” rule, and, if anything, the tropical nature of the excluded areas justifies a lengthening of time limits, not a shortening.
vide clearer language in situations where authority was divided under the N.I.L., and clear up ambiguities in fringe areas. The Code will not alter the substantial core of uniformity already achieved under the N.I.L., and it does not make any radical changes in the law of negotiable instruments as applied to commercial paper. The law of negotiable instruments under the N.I.L. consists of a mass of detailed rules, monotonous to all except a few devotees, unrelieved by exciting policy conflicts except in the area of allocating responsibility for losses caused by forgery. Under the Code, in all probability, it will remain that way.