Revised Articles 3 and 4: Substantial Changes in the UCC

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One of the principal purposes for the passage of the UCC was to make uniform the laws that people involved in business transactions would encounter in every state in the United States. A second important purpose of the UCC was to update or "fine tune" the common law principles that had existed for many years, since some of these principles no longer seemed relevant or beneficial in the latter years of the twentieth century. Few would dispute the success of the Code in achieving the twin objectives of fostering uniformity and updating the common law.

The UCC, now in effect for over a quarter century, has also been the subject of study and scrutiny. The American Law Institute and the National Conference of Commissioners on Uniform State Laws have decided that it is again time to update and change laws governing commercial transactions. They have revised Articles 3 and 4 of the UCC. Article 3 has been renamed simply, "Negotiable Instruments."

Our paper will discuss some of the major changes of this revision. As of October, 1992, nineteen states have enacted the revisions as law.

Negotiability

It has been an article of faith that an instrument must be issued payable to order or to bearer if it is to be classified as a negotiable instrument. The order or bearer terminology has frequently been referred to as the magic words of negotiability. An instrument which is made payable to order or bearer indicates the drawer's or maker's intention not to limit payment to the named payee and is therefore one of the bases for protecting later holders in due course. The traditional rule has held that an instrument not issued

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payable to order or to bearer which is later transferred to a good faith purchaser for value cannot result in the later holder becoming a holder in due course. It is well established that there can only be a holder in due course of a negotiable instrument. A transferee from the payee of a non-negotiable instrument is considered merely an assignee of the contract rights of the payee who receives no greater rights than the payee enjoyed. If the issuer, i.e., the maker or drawer, has a defense which can be asserted against the payee, the defense can be asserted against later transferees of a non-negotiable instrument since such transferees can enjoy no greater rights than the original payee.

Revised Article 3 to a large extent continues to require that the traditional ingredients be present in an instrument for it to be considered negotiable. A substantial change has been made, however, in the requirements for negotiability of checks. The revision provides that a check which otherwise meets the requirements for negotiability will not be rendered non-negotiable because it is not issued payable to order or to bearer. The official comments to Section 3-104(c) provide the reasons for the change. "Subsection (c) is based on the belief that it is good policy to treat checks which are payment instruments, as negotiable instruments whether or not they contain the words 'to the order of.' These words are almost always pre-printed on the check form and it is possible that an instrument may be written or completed on the back of the check. If the payee so desires, he can strike out these words before he accepts the check. In the past, some credit unions used check forms that did not contain the quoted words. Absence of the quoted words can easily be overlooked and should not affect the rights of holders who pay money or give credit for a check without being aware that it is not in the conventional form." Based on the official comments to the revised legislation, it is clear that the intention of the revision is to protect unambiguous areas of instruments which would in all other respects be considered checks but which lack the "order of" terminology. Inasmuch as this is generally pre-printed on checks, the revision recognizes the fact that a transferee could generally not be examining the instrument for this element and could easily overlook the fact that it is missing. The exception applies solely to checks and other instruments must contain the order or bearer terminology to be considered negotiable.

Under the traditional view, if a buyer paid for goods with a check which was non-negotiable because the check was not issued payable to the order of the payee or to the bearer, and payment of the check was stopped because of a breach of warranty concerning the goods, a subsequent good faith transferee of the check could not be considered a holder in due course. If the later holder sued the buyer, the original issuer of the check, the holder would be entitled to the defense of breach of warranty and would be treated as an assignee of the original payee-seller's rights. Under Revised Section 3-104(c), the lack of order or bearer terminology would not make the instrument non-negotiable, and later holders could be protected as holders in due course.

It should be noted that a bank money order is treated as a check even though it bears the words "money order." Accordingly, the order or bearer terminology is not essential for a bank money order to be considered negotiable.

**Particular Fund Doctrine**

The new Article 3 changes the particular fund rule as it affects the negotiability of all instruments governed by Article 3, i.e., promissory notes, checks, and drafts. It is well established that only instruments that contain unconditional promises or orders to pay money are considered to be negotiable. The traditional rule holds that an instrument must be based on the original credit of the maker ordrawer and payment must not be limited or restricted to a particular source or fund. An instrument in which the promise or order to pay is limited to payment only from a particular fund or source is considered to be conditional and therefore non-negotiable. For example, an instrument which states that it is payable only from the funds in a certain account or only from the proceeds from a particular sale is non-negotiable. Occasionally, the traditional theory is changed by orders or promises to pay only from a particular fund and from no other source, the instrument is inherently conditional because if there are not funds available in that particular fund then there exists no promise or order to utilize other funds. Therefore, the payment is conditioned upon there being a sufficient sum to provide payment for the instrument from that source alone.

Revised Section 3-106(b)(ii) provides that a promise or order is not made conditional and the instrument rendered non-negotiable because payment is limited to a particular fund or source. "This reverses the result of former Section 3-105(2)(b). There is no cogent reason why the general credit of a legal entity must be pledged to have a negotiable instrument. Market forces determine the marketability of instruments of this kind. If potential buyers don't want promises or orders that are payable only from a particular source or fund, they won't take them, but Article 3 should apply."7

Promises or orders which are subject to express conditions or subject to or governed by another writing continue to be non-negotiable under the revised Article 3. Similarly, if the rights or obligations with respect to the promise or order are stated in another writing, the instrument is non-negotiable.

**Restrictive Indorsements**
Revised Section 3-206(b) changes the rule concerning restrictive indorsements and the manner in which they must be treated by those paying an instrument. The revision provides: "An indorsement stating a condition to the right of the indorsee to receive payment does not affect the right of the indorsee to enforce the instrument. A person paying the instrument or taking it for value or collection may disregard the condition, and the rights and liabilities of that person are not affected by whether the condition has been fulfilled." Prior to revision, an indorsement on a note, "Pay A if A delivers 10 bales of hay pursuant to contract", would impose on the maker the duty to ascertain whether A in fact delivered 10 bales of hay before the instrument can safely be paid. The revision frees the maker from the duty of ascertaining whether the condition had been fulfilled.

Where the revision is not in effect, conditional indorsements on checks make them virtually uncollectible at banks since the latter will not want to undertake the risk of determining whether the condition has been fulfilled. Revised Section 3-206(b) relieves makers of notes and drawees of checks and drafts of the responsibility of determining whether conditions contained in indorsements have been fulfilled. In the example above, the note could be paid by the maker without inquiry into whether the bales of hay had been delivered. In the event the note was negotiated by A to a subsequent holder, the subsequent holder's rights are not affected by the conditional indorsement, i.e., the subsequent holder is entitled to payment irrespective of whether the bales of hay had been delivered. The rule that conditional indorsements do not prevent further transfer or negotiation of an instrument remains unchanged.

Accord and Satisfaction

The revised UCC clarifies the rules concerning the contract theory of accord and satisfaction in regard to part payment checks. Where the amount due on a contract or other legally obligated balance is illiquidated or in dispute and a check is tendered marked "paid in full", cashing the check by the creditor-payee has typically been held to be a full satisfaction of the claim barring further litigation to recover any additional sum on that claim. Of course, the matter has to be the subject of a legitimate, good faith dispute. The perceived difficulty with the accord and satisfaction concerns the vulnerability of unsuspecting parties, particularly organizations, who unwittingly cash checks marked payment in full when the creditor in fact had no desire to accept the payment as full and final payment.

Revised Article 3 continues to hold that there can be no accord and satisfaction unless the claim is unliquidated or in dispute, the "paid in full" designation is made in good faith, and the creditor cashed the check. Revised Section 3-311 provides protection to organizations who may unwittingly accept full payment checks. Revised Section 1-201(28) defines an organization to include virtually any entity other than an individual or individual proprietor. If the claimant is an organization and before the tender sends a communication that full satisfaction is to be sent to a designated person or place, a party who wishes to tender a full satisfaction instrument must comply. Checks sent to another party or part of the organization will be ineffective to create an accord and satisfaction despite the fact they are cashed by the creditor and bear a conspicuous "paid in full" designation.

An additional protection is accorded organizations which do not designate a particular person or location to receive checks tendered as full payment. The organization may avoid the result of an accord and satisfaction within 90 days of the payment of the check by tendering repayment of the check to the party who sought the accord and satisfaction. In the event, however, it is demonstrated that the claimant or an appropriate agent of the claimant had advance knowledge that the check was tendered to create an accord and satisfaction, cashing the check fully discharges the obligation and re-tendering payment within 90 days is ineffective.

Post-Dated Checks

The rule concerning post-dated checks has also been revised. Prior to revision, a post-dated check was considered an instrument payable at a future time similar to a time draft. Post-dated checks were burdensome to banks which had the duty not to pay them before the date stated on the check. In light of modern check handling of the huge numbers of checks processed daily, the revisors have deemed this to be an unreasonable burden. Revised Section 4-401 provides that a check may be post-dated, but a bank is not liable for making payment on the check before the date stated unless the drawer had given the bank prior notice. This notice must inform the bank that a post-dated check may be presented for payment and advise the bank not to make payment until the stated date. The effect of this is to put the depositor under the obligation to issue something in the nature of a stop payment order.

Secondary Liability of Indorsers

The revisors of the UCC have removed a technical requirement concerning the responsibility of holders of commercial paper who may wish to hold secondary parties liable. The traditional rule requires that an instrument be presented for payment on the due date to the maker, unless an appropriate excuse for non-presentment or delayed presentment exists. Failure to properly present on the due date discharges the secondary liability of the indorser. This
rule, in existence for many years, fails to recognize that there is little actual personal presentation of instruments in the modern business world. Revised Article 3 eliminates the requirement of presenting instruments on the due date in order to have the opportunity of holding an indorser liable in the event of non-payment. "In the great majority of cases presentment and notice of dishonor are waived with respect to notes. In most cases a formal demand for payment to the maker of the note is not contemplated. Rather, the maker is expected to send payment to the holder of the note on the date or dates on which payment is due. 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. Under former Article 3, in the small minority of cases in which presentment and dishonor were not waived with respect to notes, the indorser was discharged from liability (former Section 3-502(1)(a)) unless the holder made presentment on the exact day the note was due (former Section 3-503(1)(c)) and gave notice of dishonor to the indorser before midnight of the third business day after dishonor (former Section 3-508(2)). These provisions are omitted from Article 3 as inconsistent with practice which seldom involves face-to-face dealings."

Reporting Forged Drawer's Signature(s)

Another change concerns the amount of time a customer has to report forgeries of the customer's name as the drawer of a check. Prior to the revision, a customer that did not report a forgery of his/her name as drawer, i.e., a signature apparently issuing a check, within 14 days from the receipt of a statement showing such a forgery bore the loss for any subsequent forgeries by the same wrongdoer. The theory, of course, was that the customer's negligence in failing to warn the bank contributed to the loss.

Revised UCC Section 3-406(d)(2) expands the time for the customer to alert the bank to 30 days. This change recognizes the greater number of checks issued today by all kinds of depositors and the practical problems those depositors face in reconciling their accounts. In addition, in the event the depositor fails to alert the bank in the appropriate period of time, the depositor may still not bear the entire loss. The revisors have established a standard of comparative negligence to be applied in such cases.

The changes in the UCC described above are not of the same quantity or magnitude as those contained in the original UCC. Nevertheless, the changes are substantial. The revisors have continued to modernize and "fine tune" the law for the last portion of the twentieth century and beyond. In general, the revisions seem reasonable and based on sound business practices.