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THE PAYOR AS HOLDER UNDER ARTICLES THREE AND FOUR OF THE UNIFORM COMMERCIAL CODE

Richard B. Glickman*

Two of the most important concepts in articles 3 and 4 of the Uniform Commercial Code\(^1\) are “payment” and “transfer.” The Code, however, uses these concepts inconsistently. In some sections they are treated as having different meanings with different legal consequences,\(^2\) while in others, they are treated synonymously.\(^3\) Perhaps the reasons for this inconsistency are twofold. First, the same physical actions can constitute either “payment of an instrument” or “transfer of an instrument.”\(^4\) Second, since these concepts are nowhere defined, it would have been easy for the Code’s draftsmen to lose sight of their distinctions.

A transferee has certain duties and privileges either because of his rights as a transferee,\(^5\) or because he is a holder\(^6\) and may become a holder in due course.\(^7\) Section 3-603(2) gives transferee rights to a payor upon surrender of the instrument. It provides: “Payment or satisfaction may be made with the consent of the holder by any person including a stranger to the instrument. Surrender of the instrument to such a person gives him the rights of a transferee (Section 3-201).” This article considers the rights and duties of a payor without reference to section 3-603(2) and seeks to evaluate the merits of attaching the status of a holder or transferee to a payor.

Section 3-109(1)(d)

Section 3-109 provides:

(1) An instrument is payable at a definite time if by its terms it is payable . . . .

(d) at a definite time subject to extension at the option of the holder, or to extension to a further definite time at the option of the maker or acceptor or automatically upon or after a specified act or event.

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1 The Uniform Commercial Code is hereinafter referred to as the U.C.C. or, simply, the Code.

2 E.g., U.C.C. §§ 3-417(1), (2).

3 U.C.C. § 3-206(3): “... any transferee ... must pay or apply ... .” Cf. U.C.C. § 3-603(2), which provides that a payor shall be treated as a transferee.

4 The actions are (1) a physical transfer of the instrument, and (2) the recipient of the instrument’s giving the former possessor money, credit, a negotiable instrument, or some other agreed upon benefit. Under (1), with regard to the payor, see U.C.C. § 3-505(1)(d); with regard to the transferee, transfer seems implicit in the concept of delivery. This article does not discuss whether delivery may be constructive. Uniform Negotiable Instruments Law § 191 says that it could [hereinafter, the Uniform Negotiable Instruments Law is referred to as the N.I.L.]; U.C.C. § 1-201(14) is silent. Under (2), with regard to a payor, this benefit seems implicit from “payment or satisfaction” in U.C.C. § 3-603(1); with regard to a transferee, a transferee may become a “transferee for value” if he gives “value.” The U.C.C. refers to the above as “value.” See U.C.C. §§ 1-201(44), 3-303, 4-208. See U.C.C. § 3-201 (5) for a situation where it is important for a transferee to be a “transferee for value.”

5 U.C.C. § 3-201.

6 U.C.C. §§ 1-201(20), 3-301. See also U.C.C. § 3-201(1).

7 U.C.C. §§ 3-302, -305.
Under this section a holder can unilaterally extend the maturity date of a negotiable instrument if such a power of extension is expressly given by the terms of the instrument. The holder may have this right even without any express provision in the instrument when he retains possession of the instrument beyond its maturity date. Such retention, however, could lead to statute of limitations problems, a release of the sureties, and the stopping of interest at maturity. A provision giving a holder the right to extend alleviates some of the above problems. Because the holder changes the maturity date by extending, he would have no statute of limitations problems. However, the "stopping of interest" question would still present difficulties. If any party tenders "full payment to a holder when or after it is due [such party] is discharged to the extent of all subsequent liability for interest, costs and attorney's fees." In addition, if tender is refused, "any party who has a right of recourse against the party making the tender" is wholly discharged. Similarly, the "release of sureties" problem is only partly remedied. Although "a consent to extension, expressed in the instrument, is binding on secondary parties and accommodation makers," a refusal to accept a tender of full payment results in the release of all parties having a right of recourse against the party making the tender. In fact, it is not even clear whether the holder can be given the right to extend if any party makes a "tender of full payment . . . when or after . . . [the instrument] is due." Section 3-118(f) states in part that "a holder may not exercise his option to extend an instrument over the objection of a maker or acceptor or other party who in accordance with Section 3-604 tenders full payment when the instrument is due." Unless the "unless otherwise specified" clause at the be-

8 U.C.C. § 3-109, comment 5.
9 U.C.C. § 3-122(1). But see U.C.C. § 3-122(3) which would create no statute of limitations problems in the case of an unaccepted draft. An indorser would have the further protection of U.C.C. §§ 3-501(1)(b), -502(1)(a), and -503. A drawer would not get such further protection. U.C.C. § 3-502(1)(b).
10 The sureties could be released in two ways. First, U.C.C. § 3-501(1)(b) states that presentment "is necessary to charge any indorser." Presentment to whom is not clear. See the discussion of U.C.C. §§ 3-501, 3-502 in text accompanying notes 235-44 infra. If presentment to the primary party is sufficient to charge the indorser, this presentment is due at certain times. These times are either fixed, U.C.C. § 3-503(1)(c), or within a "reasonable time" of certain fixed times, U.C.C. §§ 3-503(1)(b), (2). "Where without excuse any necessary presentment or notice of dishonor is delayed beyond the time when it is due (a) any indorser is discharged . . . ." U.C.C. § 3-502(1)(a). "Excused" is defined in U.C.C. § 3-511. Section 3-511 does not excuse timely presentment in order that the holder may continue to receive interest on the note. Nor does it excuse timely presentment because the primary party is temporarily financially embarrassed.

Second, all sureties would be released if the holder agreed to suspend the right to enforce the instrument against the primary party. U.C.C. § 3-606. Such agreement might be expressed or implied. Perhaps an implied agreement might be inferred from the holder's retention of the instrument. However, mere retention would probably not constitute such an agreement, insofar as the holder could always seek enforcement.

An accommodation maker would not be released against a holder in due course. U.C.C. §§ 3-415(2), (3). Other accommodation parties would be treated in the capacity in which they signed. U.C.C. § 3-415(2).
11 The instrument could provide that interest runs until maturity, until payment, or it could be silent as to when interest ceases. If the instrument is silent, U.C.C. § 3-122(4) might apply so as to prevent interest from continuing until demand is made upon the primary obligor.
12 U.C.C. § 3-604(1).
13 U.C.C. § 3-604(2).
14 U.C.C. § 3-118(f).
15 U.C.C. § 3-604(2).
16 U.C.C. § 3-604(1).
ginning of the first sentence of section 3-118(f) were held to apply to the
entire subsection, the restriction quoted above might not be able to be "varied by
agreement" on the theory that by only modifying the first sentence, the draftsmen
did not intend to modify other sentences in the subsection.\textsuperscript{17} Such an interpreta-
tion would unduly restrict the parties' freedom to contract, especially since only
the parties' interests are affected by such agreements. There is no reason in the
principle of negotiable instruments why they should not be able so to agree.
Moreover, the Code draftsmen were probably especially interested in empha-
sizing that the first sentence of section 3-118(f) could be varied by agreement.
Otherwise the time limitation imposed by that sentence might have been held
unalterable since it is the only provision that limits the holder in undermining
the "definite time clause" of section 3-104(1)(c).\textsuperscript{18} Therefore, absent a rather
clear expression of the draftsmen's intent, such a limitation on freedom of con-
tract should not be read into what is possibly nothing more than an example
of poor draftsmanship.

The draftsmen thought that the holder's right to extend an instrument's
maturity indefinitely could not be given to a maker or acceptor as such because
he would then, in effect, be able to issue an instrument payable at an indefi-
nite time, violating section 3-104(1)(c).\textsuperscript{19} It should be noted, however, that
the maker-acceptor clause of section 3-109(1)(d) need not be exclusive of the
holder clause. A maker or acceptor could be a holder.\textsuperscript{20} Thus, it could be
argued that the maker-acceptor clause should only be applied when the maker
did not have possession and was not a holder, and that the holder clause be
applied if the maker or acceptor was a holder. However, such a reading of
section 3-109(1)(d) would allow the "creator" of the obligation to create a
negotiable instrument with an indefinite time period.\textsuperscript{21} At the very least, section
3-104(1)(c) seems to prevent the "creator" from doing this. Thus, in giving
the payor this right, section 3-603(2) goes too far. The above construction
would only be relevant if (1) the maker or acceptor reissued the instrument
after the maker or acceptor's extension period, (2) the instrument specified
consent to no more than a single extension, (3) the maker-acceptor period was
shorter than the original period of the instrument,\textsuperscript{22} and (4) the new holder

\textsuperscript{17} But see U.C.C. §§ 1-102(3), (4). It could be argued that the "other provisions"
phrase in § 1-102(4) does not refer to other provisions in the same section. Thus, no negative
inference could be drawn from the fact that "unless otherwise specified" was in U.C.C. §
3-118(f) but not in U.C.C. § 3-417. However, an inference might permissibly be drawn if
"unless otherwise specified" modifies the first sentence of § 3-118(f), but not the second
sentence.

\textsuperscript{18} See Britton, Formal Requisites of Negotiability—The Negotiable Instruments Law
Compared with the Proposed Commercial Code, 26 Rocky Mt. L. Rev. 1, 15-19 (1953).

\textsuperscript{19} See U.C.C. § 3-109, comment 5.

\textsuperscript{20} An instrument is not discharged when it is acquired by the party ultimately liable on it.
See U.C.C. §§ 3-601, and its comment 3, ¶ 2; but cf. N.I.L. § 119. Thus, a maker or acceptor
could become a holder.

By paying "blank" or "bearer" paper, and having such paper surrendered to himself,
any payor would fulfill the U.C.C. § 1-201(20) definition of "holder." It should be noted
that all payors can become holders of "order" paper in their own right by means of U.C.C.
§§ 3-603(2), -201(3).

\textsuperscript{21} But cf. U.C.C. § 3-118(f).

\textsuperscript{22} U.C.C. § 3-109(1)(d) states that the maker or acceptor may only extend to a further
definite time. This period of extension may be shorter than the holder's period of extension
even if the holder's period is limited by the first sentence of U.C.C. § 3-118(f).
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wanted to hold the “sureties” as a subsequent holder in due course.\(^{23}\) If the new holder wanted interest or had statute of limitations problems, and the instrument authorized a holder to extend, he could extend in his own right and need not depend on the maker or acceptor’s right to extend.

In considering whether the drawer-payor should be given a holder’s right to extend, a distinction should be drawn between a drawer with rights on the instrument and a drawer with no rights on the instrument.\(^{24}\) The former has rights against an acceptor of a draft,\(^{25}\) a certifier of a check,\(^{26}\) and a guarantor of payment.\(^{27}\) From the perspective of these parties, the drawer has the same interest as any other holder. Thus, section 3-603(2) properly seems to treat this drawer as a holder. However, such a drawer might be more like a maker than a holder since if he reissues the instrument after payment, the draft has already reached maturity and been dishonored.\(^{28}\) As a result, any subsequent taker might have rights directly against him.\(^{29}\) If the subsequent taker is afforded such rights, the reissuing drawer would seem like a “creator” of a new obligation, and section 3-603(2) would then be inappropriate. A drawer in this situation

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\(^{23}\) For a consideration of whether the new holder should be able to hold the sureties, see the discussion of § 3-208, accompanying notes 140-51 infra. A holder cannot be a holder in due course if he takes the instrument with knowledge that it is overdue. U.C.C. § 3-302(1)(c).

\(^{24}\) See U.C.C. §§ 3-208, -601(3) to determine who is discharged vis-à-vis a reacquiring drawer of an unaccepted draft. Where the draft is accepted, or the check is certified by the drawer, see note 118, infra.

\(^{25}\) The implication of U.C.G. § 3-410, when compared with U.C.G. § 3-411(1), is that no party is discharged by acceptance of a draft. See also U.C.G. § 3-412(3). U.C.G. § 3-410(1) implies that the acceptor’s liability is added. See also U.C.G. § 3-409(1) and Wachtel v. Rosen, 249 N.Y. 386, 390, 164 N.E. 326, 327 (1928). Thus, a drawer-payor who presents the instrument to the acceptor for payment should have rights on the instrument against the acceptor. However, U.C.G. § 3-413(1) says that the acceptor engages to pay the instrument “according to its tenor at the time of his engagement . . . .” (Emphasis added.) It does not say, as does § 3-413(2) on the drawer’s engagement, that “he will pay to the holder or to any indorser who takes it up.” (Emphasis added.) Thus, the acceptor undertakes to pay the instrument to the order of the holder who obtained the acceptance. Since no indorsement was made to the drawer when he paid, U.C.G. § 3-505, a payment to the drawer would not be a payment to the order of the holder who obtained acceptance. Thus, under § 3-413(1), the drawer-payor has no rights on the instrument against the acceptor. There is no reason, though, to deprive the drawer of the simplicity and lack of expense that he would have if he could sue the acceptor on the instrument. Looked at from another point of view, there is no reason to give a dishonoring acceptor the right to require the drawer to prove his case for wrongful dishonor. U.C.C. § 4-402. Such formal proof would not be necessary if the drawer, U.C.C. § 3-413(2), or a prior indorser, U.C.C. § 3-414(1), were sued. U.C.C. § 3-603(2) would allow the drawer to owe the acceptor on the instrument since that section would give the drawer his payee’s rights, and his payee, as a holder or a transferee of a holder, would have such right.

\(^{26}\) The implication of U.C.C. § 3-411(1) is that the drawer is not discharged if he holds certification. Accord, 3-411, comment 1. See Cuesta, Rey, & Co. v. Newsom, 102 Fla. 833, 136 So. 551 (1931), for an N.I.L. case giving the paying drawer rights against a drawee who certified at the drawer’s request when the drawee subsequently did not pay. The court held that the drawer was subrogated to the rights of his payee. See N.I.L. § 188.

\(^{27}\) See the discussion of § 3-416 in text accompanying notes 206-08 infra.

\(^{28}\) See U.C.C. §§ 3-503(1), -507(1), -413(2).

This author uses the term “payor” only to describe parties paying when liable. See notes 40 and 41 infra, for a discussion of a stranger-payor.

\(^{29}\) Since presentment and notice had already been given to the drawer, the terms of U.C.C. § 3-501 seem satisfied. It should be noted that such a reissued draft would be more than a note since indorsers after the reissuance probably could be charged without prior presentment and dishonor by the drawee or drawer since there had already been a dishonor. See U.C.C. § 3-414(1). It could be argued, however, that by paying the instrument the drawer has cured the old dishonor, and a new dishonor would be necessary before the drawer and the indorsers are liable.
should be given no greater rights of extension than a maker. As a practical matter, it seems unlikely that the drawer-payor would need any right of extension since he would probably not reissue a dishonored check and risk affecting his credit unfavorably.

On the other hand, there seems little reason to prevent the drawee from being given the holder's right of extension. From the standpoint of the drawer it would not make any difference who extended; in all cases he would be given the benefit of retaining his funds for a longer period if he so desired. The drawee, like the holder, has always been able to "retain possession of the instrument," i.e., defer charging the drawer's account. In fact, this deferring of the charge does not appear to be subject to statute of limitations or release of surety problems. Although the deferment would not entitle the drawee to interest, this problem is partly solved by the drawee's charging the drawer's account even though the account has insufficient funds. This charge is equivalent to a loan of the difference between the balance in the account and the amount of the draft, and it would be governed by the bank's interest rates. This approach, of course, does not give the drawee parity with the holder, because the holder receives interest on the entire amount of the draft and not merely on the amount of the overdraft. Also, the holder receives the rate of interest stated on the face of the note, rather than a fixed, standard rate. As was noted before, there seems to be no reason for treating the drawee differently, especially in light of the policy of encouraging drawees to pay and not dishonor. Section 3-603(2), however, is not helpful since without a dishonor the presentor would have no rights against the drawer.

An indorser-payor has as great an interest in the right of extension as does a holder. He might feel that his only opportunity to charge prior indorsers or drawers who are presently insolvent is to wait. He would like, however, to avoid statute of limitations and release of surety problems, but it is not clear that he can toll the statute of limitations once it starts to run. Since "notice of dishonor is a demand," and notice may be given by other parties or the holder, the statute may have started to run. Releasing the sureties presents a different problem. It is not clear whether presentment to the secondary party is necessary, whether notice of dishonor is a sufficient presentment, and whether such notice or presentment goes stale. Thus, it is not clear that the right of extension would always help the indorser-payor. Where it is helpful, however, there is no reason why the indorser should not be a holder. Even under the Negotiable Instruments Act, an indorser-payor has as great an interest in the right of extension as does a holder.

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30 U.C.C. § 3-604(3) should apply to the drawer in this situation. See U.C.C. § 1-102(1).
31 U.C.C. § 4-401 does not tell the drawee when he must charge the drawer's account.
32 U.C.C. § 3-122(3) states that the cause of action against the drawer does not accrue until demand after dishonor. If the drawee pays, there is no dishonor.
33 For practical purposes, the drawer is never released by an untimely demand. See U.C.C. § 3-502(1)(b).
34 U.C.C. § 4-401.
35 A drawer is not charged until the instrument is dishonored. U.C.C. § 3-413(2).
36 Since the drawee paid, there is no dishonor. U.C.C. § 3-507(1).
37 U.C.C. § 3-122(3).
38 See the discussion of this problem with regard to §§ 3-501, -502 in text accompanying notes 295-44 infra.
ments Law, the indorser-payor could be a holder. Thus, section 3-603(2) seems reasonable here.

If a stranger pays the instrument and retains possession, he may be giving the maker, acceptor, or drawer of an unaccepted draft the same benefits a holder would give. Often, he would have the same interests as a holder. Since, however, strangers could be makers, drawers without further rights on the instrument, or acceptors, classifying them as holders (with rights of extension and reissuance) would undermine the “definite time” policy of section 3-104(1) (c). The strength of this policy is not clear, but since it exists, it should be protected. Thus, the above strangers ought to be distinguished from other strangers. All other strangers should have this holder’s right, especially under our policy of encouraging strangers to pay. Section 3-603(2) does not make this distinction and thus goes too far.

All paying accommodation parties would want the holder’s right of extension. Although an accommodation indorser would have the same problems as an indorser-payor, there is no reason not to give him this right. Similar considerations should apply to an accommodation drawer, who might also have the indorser’s problems vis-à-vis the drawer. An accommodation maker would have the same holder problems in relation to the maker because there need not be a dishonor for him to be charged. Since, from the maker’s point of view, an accommodation maker is the same as any other holder, there is no reason not to give the accommodation maker this right. Section 3-603(2) reaches the proper result here.

Section 3-112(1) (b)

Section 3-112 provides:

(1) The negotiability of an instrument is not affected by . . .

(b) a statement that collateral has been given to secure obligations either on the instrument or otherwise of an obligor on the instrument or that in case of default on those obligations the holder may realize on or dispose of the collateral.

39 N.I.L. § 121 “remitted [the indorser-payor] to his former rights as regards all prior parties” and the indorser-payor could also further negotiate the instrument.

40 The question of whether a “stranger” is a payor is one of fact. Big Eye Min. & Mill Co. v. Livingston, 19 Ariz. 436, 171 Pac. 989 (1918). There is a legal presumption of purchase (as opposed to payment) if a stranger takes up an instrument. Citizen’s Bank & Trust Co. v. Cook, 9 La. App. 540, 121 So. 306 (1928). Directors of a company who assumed a note may be strangers. Stevens v. Laub, 38 Wyo. 182, 265 Pac. 453 (1928). See Higin v. Shoaf, 9 Ala. App. 300, 63 So. 764 (1913), aff’d, 186 Ala. 394, 64 So. 615 (1914), for a case holding that the principal obligor paid the instrument when his wife paid the instrument by means of a check drawn on her account, in which the husband had deposited all the money. The court held that there was no evidence that the principal obligor had made a gift of such money to his wife. See National Bank of Slaton v. Derhammer (No. 1), 16 Pa. D. & C. 2d 286, 288 (Lehigh County 1958), for a U.C.C. case holding that a cosignatory to an account “is not answerable out of his own funds over and above those entrusted to the joint account, for transactions made by his cosignatory which may result in an overdraft.” The court noted that U.C.C. §§ 4-104(e) and 4-212 could be read to reach a contrary result. Id. at 289. See also U.C.C. § 4-401.

41 Probably, parties obligated on an instrument can be strangers if they pay before their obligations are due. This was the law under the N.I.L. See N.I.L. §§ 88, 119, 121, 50.

42 U.C.C. §§ 3-415(1).

43 U.C.C. §§ 3-415(2), -413(1).
This section is aimed at protecting a creditor's right to obtain the benefit of any collateral given by a party to the instrument to secure any of such party's obligations, whether arising from the instrument or otherwise. Since collateral is an important part of a commercial transaction, the draftsmen felt that there was no reason to allow a statement of collateral to affect the negotiability of the instrument.  

If any party posts collateral, it would be meaningless to let him have rights to his own collateral. Thus, the maker, acceptor, or drawer without further recourse on the instrument generally has no use for the collateral. However, some taker might have put up collateral to secure all of his obligations. If he were found liable for a breach of his warranty of presentment because he was a prior transferor without good title, the above payors would argue that they are holders entitled to “realize on or dispose of the collateral.” This argument could be answered by counting that collateral is given to encourage a subsequent party to deal with the giver. Thus, any party who entered the transaction before the collateral was offered, and who was obliged to pay the instrument when presented, did not rely on the collateral and, therefore, should not get the benefit of it. If the payor sued a “relier,” however, and the relier paid, the relier could utilize the collateral. This extra step seems unnecessary. The results of section 3-603 (2) seem justified here.

The “no reliance” argument is even weaker with regard to the drawer than it is with regard to the maker or acceptor. The drawer is a surety and is thus entitled to be subrogated to his payee’s rights on the theory that it is unfair to put the ultimate loss on the surety merely because it is easier for the payee to go against him rather than against the principal. The maker and the acceptor are principals and are therefore not entitled to subrogation.

A drawee would especially want the holder’s right to the collateral if he paid a check for which there were insufficient funds in the drawer’s account. The drawee’s rights against the drawer are covered by section 4-401, which seems to contemplate only the drawee’s charging the drawer’s account for the amount of the draft. It does not appear to allow the drawee to make a secured loan to the drawer without further agreement. However, it seems reasonable to treat the instrument reciting the holder’s rights to the collateral as the “further agreement” since the drawer, or whoever else put up the collateral, was willing to do so for the benefit of all subsequent reliers including the drawee. This result would encourage more payment of checks or drafts by the drawee when the drawer has insufficient funds in his account, thus furthering the policy of section 4-401 by enhancing the acceptability of negotiable instruments.  

44 Although the word “holder” was added in 1962, the change was not intended to affect prior content. See Permanent Editorial Board for the Uniform Commercial Code, Report No. 1 — Section 3-112, Comment, 20-21 (1962).

45 For example, A issues a note to B and B collateralizes his obligations relating to the note before negotiating the note to C. These obligations could include B’s liability on the instrument, U.C.C. § 3-414(1), B’s warranties of transfer and presentment, U.C.C. §§ 3-417(1), (2), and any guarantees B made while indorsing the instrument, §§ 3-416(1), (2).

46 U.C.C. § 3-417(1)(a).

47 U.C.C. § 3-112(1)(b).

48 It is interesting to note that U.C.C. § 4-407, which states the drawee’s rights against the drawer and maker if the drawee has made an improper payment with regard to the drawer or maker, gives the drawee a holder’s rights in order to prevent unjust enrichment.
3-603(2), though, would not help the drawee-payor unless there was a breach of warranty, since no collateral giver would be liable without a dishonor,\(^{49}\) and there was none.\(^{50}\) Perhaps this result is consistent with the “finality of the transaction” approach of section 3-418. However, there should be some way for the drawee to reserve his rights to the collateral in the above situation.

Unless a distinction is made between an indorser before the collateral is offered and an indorser after it is offered, all indorser-payors should get this holder’s rights. When an indorser-payor sues the prior indorser-collateral offeror, both parties would desire rights to collateral. Section 3-603(2) reaches this result.

Since the right to the collateral would greatly influence a stranger’s decision to pay the instrument, the stranger should be given the holder’s rights here. Otherwise, he might not pay. In this situation, section 3-603(2) again reaches a sensible result.

Unless a reliance analysis is followed, all accommodation parties should have rights to the collateral. Since the obligor received the benefit of his offer of the collateral, it seems only reasonable for all parties to be able to enforce it against him as section 3-603(2) provides.

Section 3-118(a)

Section 3-118 provides:
The following rules apply to every instrument:
   (a) Where there is doubt whether the instrument is a draft or note the holder may treat it as either. A draft drawn on the drawer is effective as a note.

The purpose of this section is to encourage the free circulation of negotiable paper by precluding resort to parol evidence as to whether the instrument is a draft or a note.\(^{51}\) Thus, a holder seeking payment need not get involved in litigation merely to ascertain to whom he should present the instrument for payment. If parol evidence were admissible, any variance in the form of an instrument would adversely affect the instrument’s acceptability and credit might be disrupted.

If a maker, acceptor, or drawer of an unaccepted instrument pays, it is meaningless to give him the holder’s option since he could not utilize it because he bears the ultimate liability.\(^{52}\) If a drawer of an accepted instrument pays, he has no further rights on the instrument unless he considers it a draft. Thus, the option is important to him since it enables him to treat the instrument as a draft. If the “drawee” pays, regardless of what the instrument is, he has rights against the “drawer.”\(^{53}\) However, if the instrument is not “payable at a bank” or if it is “payable at a bank” but Alternative A of section 3-121 is not in force in the jurisdiction in question, section 3-603(2) would enable the

\(^{49}\) U.C.C. § 3-414(1).
\(^{50}\) See note 35 supra.
\(^{51}\) U.C.C. § 3-118, comment 1.
\(^{52}\) See U.C.C. §§ 3-413(1), (2), -414(1).
\(^{53}\) If a draft, see U.C.C. § 4-401; if a note, see U.C.C. § 3-121, Alternative A.
“drawee” to treat the instrument as a note and, if the “drawer” dishonors, hold all prior indorsers. This result seems to undermine the purpose of the section. The original holder elected to treat the instrument as a draft, yet, under the drawee’s option, he would be forced to retake the instrument and seek payment elsewhere. Thus, instead of avoiding inconvenience and possible litigation, section 3-603(2) requires extra effort and results in a lack of finality in the transaction.

Where there has been a past dishonor and the indorser pays, he can go against any prior indorser or the “maker-drawer.” The indorser can also always seek payment from a drawee whether or not there has been a dishonor. The holder’s option, therefore, does not affect an indorser-payor. The same considerations apply to accommodation parties. If a stranger pays and the instrument has been previously dishonored, he could go against any parties regardless of the option. However, if the stranger pays and the instrument has not been dishonored, he would be in the same position as any other holder. The reasons for giving a holder the option would apply equally to a stranger-payor. Consequently, section 3-603(2) is appropriate and necessary here.

Section 3-119

Section 3-119 provides:

1. As between the obligor and his immediate obligee or any transferee the terms of an instrument may be modified or affected by any other written agreement executed as a part of the same transaction, except that a holder in due course is not affected by any limitation of his rights arising out of the separate written agreement if he had no notice of the limitation when he took the instrument.

2. A separate agreement does not affect the negotiability of an instrument.

The purpose of this section is to make clear that, as between immediate parties, a negotiable instrument “is merely a contract.” The ordinary rule is that writings executed as a part of the same transaction are to be read together as a single agreement. . . . [Thus] the courts will look to the entire contract in writing. Subsequent nonholders in due course are assignees of the contract and are bound by the agreement in its entirety. However, because a negotiable instrument is involved, and the flow of credit facilitated by negotiable instruments is so important, a subsequent holder in due course without notice of any limitations when he took the instrument is protected from its limitations.

If a holder presents an instrument to the maker and seeks to take advantage

54 U.C.C. § 3-414(1).
55 It also undermines some of the policy of U.C.C. § 3-418. See U.C.C. § 3-418, comment 1.
56 U.C.C. § 3-414(1).
57 He can always go against a maker. U.C.C. § 3-413(1). If there has been a dishonor, as there was, he can go against a drawer. U.C.C. § 3-413(2).
58 See U.C.C. § 3-413(1), (2), -414(1), -415(2).
59 U.C.C. § 3-119, comment 3.
60 See FULLER, BASIC CONTRACT LAW 580-82 (1947).
61 Note the lengths to which U.C.C. § 3-119, comment 4, goes to protect such a holder in due course.
of a modification in the instrument made by the maker, e.g., an increased interest rate, the maker should be bound. This is the implication of section 3-119(1), since such modification would be an extension rather than a limitation of the rights of the holder in due course. Since the maker is benefited by the greater salability of his instrument, he should pay for it. If, however, the maker did not make the change, he would not and should not be bound by it, especially if the change is to his detriment. Section 3-413(1) states the maker’s engagement as paying “the instrument according to its tenor at the time of” its issuance. Thus, the maker need not pay the instrument as modified. If the maker inadvertently pays the instrument as modified, he might have an action for breach of warranty or for money had and received. If the maker sued the presentor for breach of warranty and the presentor was a holder in due course acting in good faith, the presentor would prevail. If the presentor knew that the maker was not a party to the separate agreement, the presentor might not be a holder in due course. Section 3-304(4)(b) states that “unless the purchaser has notice that a defense or claim has arisen from the terms” of the separate agreement, the purchaser does not have effective notice of a claim or defense. It could be argued that notice of a modification by a subsequent party is notice of a defense by the maker to a claim based upon such modification. However, it seems too harsh to deny the presentor the status of a holder in due course, especially if he would have been willing to enforce the instrument according to its original tenor against the maker. It is probably not sufficient notice to constitute a claim or defense when the presentor knows of a modification but does not know who the modifier is. Section 3-304(1)(a) speaks of an “instrument [bearing] such visible evidence of ... alteration ... as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay ....” However, unless the altering document and the original instrument are considered as “the” instrument for purposes of this section, section 3-304(1)(a) is not even relevant. Moreover, the ownership, validity, and proper payors are clear. Also, the terms are clear, e.g., if the presentor wants to enforce the instrument as modified and the maker dishonors, the presentor can enforce the instrument as modified against all indorsers who took the instrument subject to the modification. Even if the presentor is not a holder in due course, the warranty section might contemplate a physical alteration of the instrument.

If the maker has neither an action against the presentor for breach of warranty nor one for money had and received, he should at least have some right of action against the “altering” indorser. Otherwise, the extra expense of the modification would be borne by an “innocent” party while the party receiving the benefit of the modification bears none of its costs. Section 3-603(2) is irrelevant since it merely gives the maker the presentor’s rights vis-à-vis the

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62 This is the theory of U.C.C. § 3-407, but that section might only contemplate physical alterations on the instrument. “Alteration” is undefined.
63 U.C.C. § 3-417(1)(c).
64 U.C.C. § 3-418 might not prevent an action for money had and received here since the presentor might be neither a holder in due course (see the discussion in the text) nor a good faith relier since he knew of the modification.
65 U.C.C. § 3-417(1)(c)(1).
66 U.C.C. § 3-414(1).
alterer; and since the maker paid and is thus discharged, the "alterer" is also discharged. Therefore, the maker's only recourse against the "alterer" is an action for unjust enrichment. The above analysis would also apply to a drawer and an acceptor.

If a drawee pays a holder in due course and the drawer made the "modification," the drawee can charge the drawer's account. If the drawer did not make the modification, however, the drawee cannot charge his account since the drawee may only charge the drawer's account with any item which is otherwise properly payable from that account. "Properly payable" would seem here to refer to items that the drawer engages to pay, that is, the amount of his order to the drawee. If the drawee cannot charge the drawer, he should not bear the ultimate liability for the amount of the alteration, or "unjust enrichment" will result. Section 3-603(2) probably would not help the drawee charge the alterer. The drawee might, however, have a breach of warranty action against either the payor or the alterer since the "holder in due course acting in good faith" exceptions to the warranty against material alteration do not apply to a drawee-payor. The drawee would also have an unjust enrichment action against the alterer.

Regardless of whether an indorser-payor knew of any modifications when he originally took the instrument, a subsequent holder in due course without notice could enforce the instrument according to its original tenor. The interesting question is whether the indorser-payor who originally took the instrument with knowledge of its modification can then enforce it against the modifying maker or drawer according to its original tenor. The indorser-payor cannot be a holder in due course in his own right. Section 3-603(2) might not help him either since it refers to section 3-201, which does not allow a transferee who has himself been a party to any fraud or illegality affecting the instrument or who as a prior holder had notice of a defense or claim against it... [to] improve his position by taking from a later holder in due course.

Although the modification would probably not be considered a fraud or illegality, the indorser-payor might be held to have had notice of a defense because he knew of the modification and, therefore, originally could not have attempted to enforce the unmodified instrument. Such notice might not be considered "notice of a defense," however, as that term is used in the U.C.C. The indorser

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67 U.C.C. § 3-601(3).
68 See U.C.C. § 1-103.
69 U.C.C. § 4-401.
70 U.C.C. § 4-401.
71 U.C.C. §§ 3-413(2), -104(2)(a). U.C.C. § 4-406(1) gives the drawer the right to an adjusting credit on any altered instrument charged to his account. This section might not help the drawer here since it speaks of "any alteration on an item." (Emphasis added.) Thus it may be referring to writing on the item.
72 See note 35 supra.
73 See U.C.C. § 3-417(1)(c).
74 U.C.C. § 1-103.
75 He would not pay unless there had been a dishonor. U.C.C. § 3-414(1). A person with notice of a dishonor cannot become a holder in due course in his own right. U.C.C. § 3-302(1)(e).
76 U.C.C. § 3-304.
would have a cause of action against the “modifier” for unjust enrichment, but that action would only help the indorser if the amount of the instrument or the amount of the interest had been reduced. If the maturity date had been extended, the indorser would have no rights against the modifier.

If the indorser were unaware of the modifications and not a holder in due course when he originally took, and if he paid a holder in due course according to the original tenor of the instrument, section 3-603(2) would enable him to enforce the instrument according to its original tenor. This result is probably reasonable since he did not originally know of the modification and therefore could not take steps to protect himself. If the above indorser paid a nonholder in due course according to the instrument’s original tenor, he could not similarly enforce the instrument since he would not be a subsequent holder in due course without notice. If he does not have an action against his presentor for money had and received, he might have a breach of presentment warranty action against him. Also, if he had been a transferee for consideration or a holder, he might have a breach of transfer warranty action against his transferor or a prior indorser because a defense exists as to part of such transferor or indorser’s claim. Unless the maker or indorser were held to be a transferor for purposes of the warranty section and the modifying agreement was considered a material alteration, the indorser’s only right of action against such parties for the original amount of the instrument would be a suit for unjust enrichment.

If a stranger without notice of the limitation pays a nonholder in due course before dishonor, section 3-603(2) would probably allow him to become a holder in due course. Although this result goes beyond subrogating the stranger to the rights of his presentor, it seems consistent with the purposes of section 3-119 and a necessary adjunct of the policy of encouraging strangers as payors. If a stranger knew of the limitation and paid a nonholder in due course, he would be bound by the limitation. If a stranger knew of the limitation but paid a holder in due course subject to it, he would also be bound by the limitation. Unless he was a prior holder or a “party to the fraud,” a stranger who knew of the limitation and paid a holder in due course not subject to the limitation would take free of the limitation on the theory that the market of a holder in due course should not be diminished.

The same considerations that applied to an indorser should also apply to an accommodation party. However, it must be remembered that an accommodation maker or an accommodation drawer might have the maker or drawer’s holder-in-due-course problem if he sues on a breach of warranty. This result is

77 See U.C.C. § 3-119, comment 2; but cf. N.I.L. § 121.
78 See note 75 supra.
79 See the good-faith-relier provision of U.C.C. § 3-418.
80 U.C.C. § 3-417(1)(c). Note that there would not be any holder-in-due-course problems, but the presentor could then sue him for breach of his transfer warranty. U.C.C. § 3-417(2)(c). Thus, a circle would exist and nothing would be accomplished.
81 U.C.C. § 3-417(2)(d).
82 U.C.C. § 3-119, comment 2.
83 U.C.C. § 3-119(1).
84 U.C.C. § 3-119(1).
85 See note 41 supra.
86 See U.C.C. §§ 3-603(2), -201(1).
reasonable since the public normally cannot distinguish a maker from an accommodation maker and a drawer from an accommodation drawer.\footnote{\cite{UCCsec3-415(3)}}

Sections 3-202 and 3-204(3)

Section 3-202 provides:

(1) Negotiation is the transfer of an instrument in such form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with any necessary indorsement; if payable to bearer it is negotiated by delivery.

(2) An indorsement must be written by or on behalf of the holder and on the instrument or on a paper so firmly affixed thereto as to become a part thereof.

(3) An indorsement is effective for negotiation only when it conveys the entire instrument or any unpaid residue. If it purports to be of less it operates only as a partial assignment.

(4) Words of assignment, condition, waiver, guaranty, limitation or disclaimer of liability and the like accompanying an endorsement do not affect its character as an indorsement.

Section 3-204 provides:

(3) The holder may convert a blank indorsement into a special indorsement by writing over the signature of the indorser in blank any contract consistent with the character of the indorsement.

The purpose of section 3-202 is to allow a holder of an instrument to transfer it in such form that the subsequent taker will be easily recognized as the presumptive owner by those dealing with him.\footnote{\cite{UCC3-415(3)}} Section 3-204(3) is simply a special means of transfer whereby the holder of blank or bearer paper can protect himself and his transferee from loss or theft of the instrument, while still permitting the transferee to become its presumptive owner.

Since an instrument is not discharged when it is acquired by the party ultimately liable on it,\footnote{\cite{UCC3-601}} a maker-payor might want to reissue it.\footnote{\cite{NII119}} Section 3-208 provides one method of accomplishing reissuance, but it may require the maker to cancel all indorsements before he can reissue.\footnote{\cite{UCC3-208}} Such cancellation might be

\begin{footnotes}
\item[Cf.] Cf. \textit{U.C.C.} § 3-415(3). There probably would not be a circularity problem since accommodation parties do not warrant.

\item[Dean Ames] Dean Ames had argued that it was not the function of an accommodation party to give warranties and this view was adopted in the 1952 and 1958 Texts. This policy decision was carefully considered and the Editorial Board is not persuaded that it should reverse this decision. \textit{Permanent Editorial Board for the Uniform Commercial Code, Report No. 1—Rejection of Proposed Section 3-415(6)}, 74-75 (1962).

\item[\cite{UCC3-201(3)}] U.C.C. §§ 3-201(3), last sentence; -307(2).

\item[\cite{UCC3-601}] U.C.C. § 3-601, and its comment 3; \textit{but cf.} \textit{N.I.L.} § 119.

\item[\cite{UCC3-104(1)(b)}] A maker might want to issue his note conditionally. This cannot be done if the note is a negotiable instrument. \textit{U.C.C.} § 3-104(1)(b). However, a conditional indorsement of a negotiable instrument is possible. \textit{U.C.C.} § 3-205(a).

\item[\cite{UCC3-208}] He cannot renegotiate the instrument without being a holder. See text accompanying notes 92-96 \textit{infra}. Arguably, he cannot reissue the instrument without returning it to its original form by cancelling all indorsements. At its issuance the instrument did not contain indorsements. Thus, at its reissuance the instrument should not have any indorsements, a reissuance being merely another issuance of the same instrument. This approach is consistent with the second paragraph of the comment to \textit{U.C.C.} § 3-208, which says that "on further negotiation \ldots the [reacquirer] may or may not cancel intervening indorsements." It only speaks of
\end{footnotes}
undesirable for the maker since the indorsements might improve the instrument’s marketability. Section 3-202 might provide a means of “reissuance” that retains all indorsements. Although the maker-payor of blank or bearer paper could use section 3-202, the maker-payor of order paper could not unless he is a holder.

Section 3-505, which states the rights of “the party to whom presentment is made,” does not give the payor the right to demand the presentor’s indorsement. However, section 3-603(2), by means of section 3-201(3), does give him this right. Perhaps a policy might be inferred from section 3-505 in that it is preferable to have a reissuing maker cancel all indorsements since such indorsers have, in effect, fulfilled their obligations. There may also be a feeling that if the maker reissues, the public should be given some notice that the instrument is being reissued. This latter suggestion, however, lacks merit since the public has no right to written notice on the face of the instrument of the number of prior notes the maker has issued. There is no difference between the reissuance of an instrument with all indorsements cancelled and the issuance of a new instrument. The first argument, which prefers reissuing makers to cancel all indorsements, also might be reading too much into section 3-505. Under the N.I.L., a maker who paid on maturity discharged the instrument. Thus, the maker-payor did not need the right to receive an indorsement. Similarly, an indorser-payor did not need an indorsement since he was specifically told that “he may strike out his own and all subsequent indorsements, and again negotiate the instrument.” Hence, under N.I.L. § 74, which lists the rights of a party to whom presentment is made, one never had to consider whether a payor should be given the right to receive his presentor’s indorsement. But under the U.C.C., since neither the instrument is discharged nor the indorser specifically told how to negotiate further, the drafters had to decide whether the payor should have

negotiation and not reissuance. However, the language of § 3-208 makes no such distinction. “Where an instrument is returned to or reacquired by a prior party he may cancel any indorsement which is not necessary to his title and reissue or further negotiate the instrument . . . .” (Emphasis added.)

92 U.C.C. §§ 3-111, -204(2).
93 U.C.C. §§ 3-202(1).
94 U.C.C. §§ 3-110(1), -204(1).
95 U.C.C. §§ 3-202(1), (2).
96 U.C.C. § 1-201(20).
97 It could be argued that since U.C.C. § 3-505 does not allow a payor to demand his presentor’s indorsement, since a payor must be a holder to negotiate, U.C.C. §§ 3-202(1), (2), and since a payor is specifically given the right to negotiate, U.C.C. § 3-208, the drafters contemplated that cancellations would be necessary before the instrument could be further negotiated. Although such a cancellation would not be necessary with regard to bearer paper, the drafters might not have contemplated the situation where A issues to B; B specifically indorses to C; C indorses in blank; X, presentor, presents to B after A dishonored; and B seeks further to negotiate the instrument. They might have only considered X presenting to C. Besides, there does not seem to be any policy reason to allow B to negotiate without cancelling, but to prevent B from so negotiating if C had specifically negotiated the instrument to X. In either case, C would be liable on the instrument for a period beyond maturity.

An accommodation maker’s signature need not be cancelled by a reissuing maker. Section 3-208 speaks only of cancelling indorsements. However, he may be discharged against a nonholder in due course.

98 N.I.L. § 119.
99 N.I.L. § 121. For a more complete statement of the law under the N.I.L. see 1955 N.Y.L. REV. COMM’N, STUDY ON THE UNIFORM COMMERCIAL CODE, REPORT ON SECTION 3-208, at 874-76.
this right. Although section 3-505 would be the natural place for the draftsmen to deal with the problem, it could be argued that section 3-505 was only aimed at amending N.I.L. § 74 and that the problem was considered and solved in section 3-603(2). Perhaps this interpretation is bolstered by section 3-208, which does not require cancellation and is authority that subsequent holders in due course will be able to hold prior indorsers. Interestingly, however, the drafters appear to have given some consideration to this problem in section 3-505. N.I.L. § 74 only gave the payor the right to receive the instrument after payment. Section 3-505(1)(d) goes further, allowing the payor, upon payment, to demand a signed receipt as well as the surrender of the instrument. If the payor has the right to require indorsement, it is difficult to see why he is given the right to demand a signed receipt.

Assuming that there is an ambiguity in the Code, the courts should follow the more just result. Professor Chafee, who argued for a section 3-603(2) approach to all reacquisitions under the N.I.L., sought to distinguish payments made before and after maturity. He argued that secondary parties should not be discharged against purchasers from reacquirers who reacquired before maturity on the ground that such secondaries were adequately protected against the reacquirer and had agreed to stand as “surety” until maturity. Also, the circularity problem that would exist with regard to the reacquirer, would not exist with regard to a taker from the reacquirer. After maturity, however, the secondaries have fulfilled their obligation and should be discharged. Under the section 3-603(2) approach, Professor Chafee's distinction is not drawn, and all payors are given the right to receive the indorsement of their presentor. But the existence of this right does not affect the indorser's liability on the instrument as substantially as it would appear, since section 3-208 gives rights to subsequent holders in due course only against indorsers, whose indorsements are unnecessary to the reacquirer's title. If a taker from a reacquirer after maturity or after dishonor has notice that he took after dishonor or after maturity — as he often does — he could not be a holder in due course in his own right. He also might not be a holder in due course in his own right, at least for purposes of section 3-208, if he knew of the reacquisition at the time of his acquisition. Since he knew of the reacquisition, he had notice of the discharge, and thus, would not be protected by section 3-602. Since section 3-208 seems to be only an application of the principle of section 3-602, such taker should not be afforded the protection of a subsequent holder in due course. Moreover, he has notice of

100 U.C.C. § 3-505, comment on Prior Uniform Statutory Provision.
101 See note 91 supra, for a situation where cancellation before reissuance seems necessary.
103 N.I.L. §§ 50, 121.
104 N.I.L. § 50.
105 See Britton, Bills and Notes, § 300 n.3 (1961), for an argument that secondaries should never be discharged as against purchasers from reacquirers. Britton feels that a seller should always be given the right to sell the most marketable instrument. He relies upon a broad interpretation of State Finance Corp. v. Pistorino, 245 Mass. 402, 139 N.E. 653 (1923).
106 U.C.C. § 3-302(1)(c).
107 U.C.C. § 1-201(25)(c).
108 Accord, U.C.C. § 3-305(2)(e).
109 See U.C.C. § 3-208, comment, ¶ 1.
the secondary party's defense if the reacquirer should attempt to hold him liable. A holder in due course is "a holder who takes the instrument ... without notice ... of any defense against ... it on the part of any person." 1110 Although it could be argued that a subsequent holder in due course also means a taker subsequent to the reacquisition who has the rights of a holder in due course—that is, a taker from a holder in due course who receives the rights of that holder under the shelter principle of section 3-201(1)—such an interpretation seems to deprive the word "subsequent" of its proper meaning.

In addition, if the instrument, dishonored before the maker reacquired, 1111 was not presented to the indorser within a reasonable time after dishonor, 1112 the indorser would be discharged against all parties but a subsequent holder in due course. 1113 These provisions do not, however, protect all secondary parties after maturity. For example, if a demand, bearer note was reacquired after demand and dishonor, but the dishonor was not noted on the instrument and the reacquirer sold through an agent who disclosed to the buyer neither the reacquisition nor the prior demand, the taker could hold the secondaries. It does not seem fair to allow the reacquirer to sell without cancelling in order to protect his market when such protection could hurt innocent parties. Furthermore, under section 3-208, the purchaser from the reacquirer often has no rights against the indorsers, who are unnecessary for the reacquirer's title. Thus, it seems inequitable to permit the reacquirer to lull his purchasers into thinking that they are taking a more secure instrument than they are actually getting. 1114 Fairness to both the purchaser from the reacquirer and the "unnecessary" indorser would seem to require cancellation before reissuance if payment is after maturity. The maker-payor should always be required to use the section 3-208 method. These same considerations also apply to acceptors, drawers, 1115 and indorsers.

If a drawee-payor wished to reissue an instrument paid after maturity, its acceptance 1116 might be sufficient. This approach seems especially appropriate with regard to a situation involving a check where, upon certification procured by a holder, all parties are discharged and, in effect, a new instrument is created. 1117 With regard to a draft, however, nobody is discharged, although the drawee's engagement has been added. 1118 Thus, contrary to section 3-603(2), cancellation before reissuance also seems appropriate in this situation.

Standing alone, the implication of section 3-505 is that a stranger paying the

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110 U.C.C. § 3-302(1).
111 E.g., U.C.C. § 3-121, Alternative A.
112 U.C.C. §§ 3-501(1)(b), -503(1)(e).
114 It is not clear whether cancellation releases a prior indorser from his warranty. U.C.C. § 3-605 only speaks of "discharge" by cancellation. If cancellation also releases the indorser from his warranty, and if a purchaser from a reacquirer would otherwise have this warranty (see the discussion of § 3-208 in text accompanying notes 140-51 infra), some method should be developed to discharge parties from their engagement on the instrument, but not from their warranty.
115 It should be noted that the U.C.C. abolishes the rule of Beck v. Robley, 1 H. Bl. 89, 126 Eng. Rep. 54 (C.P. 1774), which had been codified in N.I.L. § 121(1).
116 U.C.C. § 3-410(1).
117 U.C.C. § 3-411(1). Note the difference if the drawer obtains certification. U.C.C. § 3-411, comment 1.
118 U.C.C. § 3-410(1); Wachtel v. Rosen, 249 N.Y. 386, 164 N.E. 326 (1928).
instrument cannot demand the presentor’s indorsement. Unless one is willing to say that once an instrument is paid, it should no longer be negotiated, the stranger should be able to procure his presentor’s indorsement. Any other position would require unnecessary regulation of the economy. Thus, section 3-603(2) appropriately gives the stranger-payor the right to demand his presentor’s indorsement.

Accommodation parties present the additional problem of whether an instrument, once paid, should be further negotiable. However, unlike strangers, all accommodation parties except accommodation makers pay after maturity and dishonor. Also, such payment serves as a discharge of parties who would have had a right of recourse against them. Thus, it would seem appropriate to make them cancel the indorsements of all discharged parties before permitting them to negotiate the instrument further. Section 3-208 cannot be utilized for this purpose, even for an accommodation maker or an accommodation drawer, since that section speaks of reacquire and return, and such words imply that the prior party had possession of the instrument at some past time. This language is inapplicable to accommodation parties. Thus, an accommodation party must be given the right to obtain the indorsement of his presentor if he is to be permitted to negotiate the instrument further. Section 3-603(2) would achieve this result but would not require cancellations.

Sections 3-206 and 3-603(1)(b)

Section 3-206 provides:

(1) No restrictive indorsement prevents further transfer or negotiation of the instrument.

(2) An intermediary bank, or a payor bank which is not the depositary bank, is neither given notice nor otherwise affected by a restrictive indorsement of any person except the bank’s immediate transferor or the person presenting for payment.

(3) Except for an intermediary bank, any transferee under an indorsement which is conditional or includes the words "for collection", "for deposit", "pay any bank", or like terms (subparagraphs (a) and (c) of Section 3-205) must pay or apply any value given by him for or on the security of the instrument consistently with the indorsement and to the extent that he does so he becomes a holder for value. In addition such transferee is a holder in due course if he otherwise complies with the requirements of Section 3-302 on what constitutes a holder in due course.

(4) The first taker under an indorsement for the benefit of the indorser or another person (subparagraph (d) of Section 3-205) must pay or apply any value given by him for or on the security of the instrument consistently with the indorsement and to the extent that he does so he

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119 Technically, this result is not clear. Although it is consistent with the theory of U.C.C. § 3-601(3), it does not come within the literal language of that section since an accommodation party does not reacquire and he still has recourse on the instrument. U.C.C. § 3-415(5). It could be argued that U.C.C. § 3-606 covers this situation on the theory that a presenter who seeks payment from an accommodation party has released the accommodation party. U.C.C. § 3-603(1). Thus, all parties who, to the knowledge of the presenter, have rights against the accommodation party are also released. However, it could be argued that the statute, not the presenter, releases the accommodation party. Therefore, U.C.C. § 3-606 would be inapplicable. The same problem of release exists when an indorser or a drawer of an accepted instrument pays.

120 U.C.C. § 3-415(1).
becomes a holder for value. In addition such taker is a holder in due course if he otherwise complies with the requirements of Section 3-302 on what constitutes a holder in due course. A later holder for value is neither given notice nor otherwise affected by such restrictive indorsement unless he has knowledge that a fiduciary or other person has negotiated the instrument in any transaction for his own benefit or otherwise in breach of duty (subsection (2) of Section 3-304).

Section 3-603 provides:

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

(b) of a party (other than an intermediary bank or a payor bank which is not a depositary bank) who pays or satisfies the holder of an instrument which has been restrictively indorsed in a manner not consistent with the terms of such restrictive indorsement.

These sections, designed to protect a restrictive indorser, do not clearly delineate the status of a transferee who "pays or applies value" in disregard of a restrictive indorsement. Under the 1950 Proposed Final Draft and the 1952 version of the Code, the transferee was a holder subject to the rights of his indorser if the restrictive indorsement had been conditional, and a holder subject to an obligation as a fiduciary if the restrictive indorsement was for the benefit of the indorser or another person. Under the 1962 version of the Code it is not clear whether the transferee is a holder.

It could be argued that the restrictive indorsement is not effective until the terms of the restriction are fulfilled. If this approach is not taken, and the transferee is a holder, it is not clear that he cannot be a holder for value and even a holder in due course. Section 3-206(3) says only that the transferee must apply any value given by him consistently with the indorsement, and to the extent that he does so, he becomes a holder for value. It does not say that he could not be a holder for value, however, if he disregarded the restrictive indorsement but gave value. Similarly, the notice effect of a restrictive indorsement is unclear. Section 3-304 does not speak of a restrictive indorsement giving notice of a claim or defense, although it may be implied from section 3-206(4) that a section 3-206(3) restrictive indorsement does give such notice. Thus, a literal and slightly perverse reading of the U.C.C. could undermine the protection intended for the restrictive indorser. If the transferee is not a holder

121 See U.C.G. § 3-205 in both the Proposed Final Draft (1950) and the Official Text (1952).
123 This result would be consistent with the policy of U.C.G. § 3-207, comment 2. Perhaps U.C.G. § 3-206(1) also leads to the conclusion that the transferee is a holder. However, that section could be interpreted as an analogue of U.C.G. § 3-205(b).
in due course, his rights in the instrument are not greater than his transferor's.\textsuperscript{124} This could play havoc with section 3-206(4) if "transferor's rights" are interpreted as the same rights as the transferor had since that section generally affects only the first taker from the restrictive indorser. For example, if A issues a check to B; B indorses the check "to C for the benefit of B"; C negotiates the check to D to pay his own personal debt; and D negotiates the check to E, an innocent purchaser for value who takes the check more than thirty days after it was first issued, E could not be a holder in due course since he would have notice that it is overdue.\textsuperscript{125} E would therefore only have his transferor's rights.\textsuperscript{126} Depending on how section 3-206 is read, E's transferor, D, might be bound to hold the check for the use of B since he knew that C, a fiduciary, had "negotiated the instrument . . . for his own benefit."\textsuperscript{127} This limitation, however, might not apply to E, since

\begin{quote}
a later holder for value is neither given notice nor otherwise affected by such restrictive endorsement unless he has knowledge that a fiduciary or other person has negotiated the instrument in any transaction for his own benefit.\textsuperscript{128} (Emphasis added.)\end{quote}

E is a holder for value without knowledge of any negotiation in breach of duty. Of course, this conflict as to the extent of E's rights could be resolved by reading section 3-206(4) into section 3-201(1) so that E would be given all of D's rights and liabilities except D's fiduciary duty to B. Such a solution would be sensible.

Section 3-603(1)(b) protects a restrictive indorser from a "disregarding" payor. It could be argued that this section is not consistent with section 3-206(4), which requires only the first taker to act consistently with the restrictive indorsement. "A later holder for value is neither given notice nor otherwise affected unless he has knowledge" that the instrument was negotiated in breach of a fiduciary duty. Section 3-603(1)(b) speaks only of paying the holder "in a manner not consistent with the terms of the restrictive indorsement." Thus, it seems to treat all restrictive indorsements as notice to a payor.\textsuperscript{129}

At first glance, section 3-206 appears to cover situations where the maker "pays" in disregard of a restrictive indorsement. However, section 3-206(3) speaks of a "transferee," and a maker-payor is not a transferee.\textsuperscript{130} Also, both sections 3-206(3) and 3-206(4) reward proper conduct by making the "transferee" or "taker" a holder for value. A maker-payor could not be a holder for

\textsuperscript{124} U.C.C. § 3-201(1).

\textsuperscript{125} U.C.C. §§ 3-304(3)(c), -302(1)(c).

\textsuperscript{126} U.C.C. § 3-201(1).

\textsuperscript{127} U.C.C. § 3-206(4).

\textsuperscript{128} U.C.C. § 3-206(4).

\textsuperscript{129} A curious aspect of U.C.C. § 3-206 is that it considers the effect of restrictive indorsements on the drawee. This problem could be adequately handled in Article four. It seems somewhat out of place in § 3-206 since the drawee is not interested in becoming a holder for value.

\textsuperscript{130} A payor is not a transferee. Otherwise U.C.C. § 3-603(2) which gives the payor the rights of a transferee would be unnecessary. Furthermore, U.C.C. § 3-417 draws a distinction between presentment warranties (for payors) and transfer warranties (for transferees). If the payor were a transferee, the presentment warranties would be meaningless.
all purposes since a holder receives the benefit of the transfer warranties, \textsuperscript{131} which in the hands of a maker-payor would undermine the presentment warranties. \textsuperscript{132} Comment 5 to section 3-206, therefore, appropriately refers payors to section 3-603(1)(b). These same considerations also apply to a drawer.

An indorser-payor who pays the instrument in disregard of a restrictive indorsement does not need to become a holder for value to negotiate the instrument further. He could take advantage of section 3-208. If the dishonor were not noted on the instrument, the subsequent takers might become holders in due course and, thus, free from the restrictive indorser's claims to the instrument. The restrictive indorser, however, could probably bring a section 3-804 suit against the indorser-payor. If "lost" were read literally despite the use of "otherwise" in apposition to "lost," the restrictive indorser could probably sue the indorser-payor in conversion.\textsuperscript{133} Thus, the restrictive indorser has sufficient protection against an indorser-payor.

Where a stranger or an accommodation party\textsuperscript{134} paid in disregard of a restrictive indorsement, section 3-603(2) would only give him the rights of his presentor. Hence, the restrictive indorser would be sufficiently protected in these situations.

Section 3-207

Section 3-207 provides:

(1) Negotiation is effective to transfer the instrument although the negotiation is
(a) made by an infant, a corporation exceeding its powers, or any other person without capacity; or
(b) obtained by fraud, duress or mistake of any kind; or
(c) part of an illegal transaction; or
(d) made in breach of duty.

(2) Except as against a subsequent holder in due course such negotiation is in an appropriate case subject to rescission, the declaration of a constructive trust or any other remedy permitted by law.

The purpose of this section is to further the acceptability of negotiable instruments as instruments of credit, while affording reasonable protection to "victimized" parties. This aim is accomplished by codifying the principle that "any person in possession of . . . [a negotiable] instrument which by its terms runs to him is a holder, and that anyone may deal with him as a holder,"\textsuperscript{135} but by allowing the "victim" any necessary relief against all parties but a subsequent holder in due course.

If a payor deals directly with an infant or other individual lacking capacity, it is unlikely that such individual would want rescission unless the payment had been at a discount. If the presentor does seek rescission, it would probably be granted since this is the type of problem at which section 3-207 is directed.

\textsuperscript{131} U.C.C. § 3-417(2).
\textsuperscript{132} U.C.C. § 3-417(1).
\textsuperscript{133} U.C.C. § 1-103.
\textsuperscript{134} U.G.C. § 3-415(5) gives the accommodation party an immediate right of recourse against the party accommodated. However, the accommodation party's status in such suit as a holder or a holder in due course is determined through U.G.C. § 3-603(2).
\textsuperscript{135} U.C.C. § 3-207, comment 2.
However, a problem arises when an infant negotiates an instrument to a third party who then seeks payment from a payor who cannot be a holder in due course in his own right, and the infant seeks rescission against the payor. Section 3-207(2) allows the infant rescission or any other appropriate remedy against all possessors "[e]xcept . . . a subsequent holder in due course." The payor is probably not a subsequent holder in due course. Thus, rescission seems proper. However, section 3-603(1) discharges any party's liability to the extent of such party's payment or satisfaction to a holder, even if such payment were made with knowledge of another person's claim to the instrument. It seems unfair to require a payor to pay and then allow the infant who mistakenly sold the draft at a discount to cause the payor to take his loss. Such a result might make people less willing to use negotiable instruments, the very thing section 3-207 is trying to avoid.

Section 3-207(2) is qualified by the phrase "in an appropriate case," and it could be argued that payment by an innocent payor is an appropriate case for denying rescission, especially if the payor fulfilled all the requirements necessary to become a holder in due course except the notice of dishonor requirement. However, comment 5 makes it clear that "in an appropriate case" refers to the appropriate remedy under the law of the appropriate jurisdiction.

Section 3-208 provides:

Where an instrument is returned to or reacquired by a prior party he may cancel any indorsement which is not necessary to his title and reissue or further negotiate the instrument, but any intervening party is discharged as against the reacquiring party and subsequent holders not in due course and if his indorsement has been cancelled is discharged as against subsequent holders in due course as well.

The purpose of this section is to clarify the parties who are discharged against a reacquiring party and his transferee. Unlike N.I.L. § 121, this section does not give status to the reacquirer, i.e., tell the payor whether he is a holder in due course. That is done by section 3-603(2).

A general problem in this section involves the meaning of the word "dis-
charge." Confusion arises in two situations. First, if \( X \) presents an instrument to the drawee for acceptance and the drawee returns the instrument to \( X \) after acceptance, the drawee would seem to be discharged as against \( X \) and any non-holder in due course taking from \( X \). This result is achieved since "any intervening party [i.e., a party to the instrument after the reacquirer first held the instrument and before he reacquired it] is discharged as against the reacquiring party and subsequent holders not in due course." An acceptor is probably a "party" since the word is defined as "a person who has engaged in a transaction or made an agreement within this Act." Furthermore, the making of an acceptance would seem to be a "transaction . . . within this Act" since it is defined in article 3. This result would make the act of acceptance meaningless. Even stranger results would be produced where the reacquirer was a holder who had obtained certification. In that case, the drawer and all indorsers would be discharged along with the certifier. Thus, instead of effecting a novation, the reacquirer would be discharging all parties to the instrument. The drafters probably intended to discharge only intervening indorsers, rather than all intervening parties. This result would be consistent with the first part of section 3-208 and with section 3-606, to which section 3-208 is analogous.

The second problem involving "discharge" is to decide whether the drafters intended only to discharge the party's liability on the instrument or to release the party from his warranty in addition. If it means the latter, it goes too far. For example, suppose that \( A \) issues a check to \( B \), whose special indorsement to \( C \) is forged. \( C \) presents it to the drawee, who dishonors. \( C \) then presents to \( A \), who pays. \( A \) subsequently learns of the forgery and would like to sue \( C \) for breach of his warranty of good title. Such a suit would be in keeping with the Code policy of passing the risk of ultimate loss to the person who dealt with the wrongdoer. It would also be consistent with the wording of section 3-417(1): "Any person who obtains payment . . . warrants to a person who in good faith pays . . ." (Emphasis added.) The only case in point; however, Ray v. Livingston, denied the purchaser from the reacquirer a breach of warranty action.

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141 U.C.C. § 3-208.
142 U.C.C. § 1-201(29).
143 U.C.C. § 3-410(1).
144 See U.C.C. § 3-411(1).
145 It is not clear whether an accommodation maker or an accommodation drawer is contemplated when U.C.C. § 3-208 speaks of "[cancelling] any indorsement which is not necessary to [the reacquirer's] title." See the discussion under § 3-202 supra, as to whether an accommodation maker or accommodation drawer's signature should be cancelled. U.C.C. § 3-605 would permit such cancellation.
146 But see Britton, op. cit. supra note 104, § 299, for his view that under the N.I.L. the reacquirer should not be able to sue his presenter on either the instrument or the breach of warranty. He argues that the avoidance of the circularity problem, the rationale for preventing the reacquirer from suing his presenter on the instrument, also applies to the reacquirer suing the presenter on the warranty. However, this conclusion is not always correct. The reacquirer might have had good title when he negotiated the instrument, but a subsequent indorsement might have been forged so that the presenter did not have a good title. See N.I.L. §§ 65(2), 66(1). It should be noted, however, that § 65 speaks of "negotiation" and not "presentment," while § 66 refers to "all subsequent holders in due course" and the reacquiring payor might not be a subsequent holder in due course. Britton would allow a purchaser from the reacquirer to sue on the warranty.
147 U.C.C. § 3-417(1)(a).
148 204 N.C. 1, 167 S.E. 496 (1933). This is an N.I.L. case decided on a stipulated set of facts.
against an "intervening" indorser. In that case a forged note was issued to A, who indorsed it to B, who indorsed it to C. Four subsequent indorsements were then forged. A reacquired and indorsed the instrument to X, who sued B on a breach of warranty action. Despite the fact that both sides stipulated that when X became a "holder" he had no notice of any previous dishonor, that he took the instrument in good faith and for value, and that he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it, the court held that B was not liable on his warranty to X because X took through a payee who could not have recovered on the instrument. This decision has been criticized as "clearly wrong": "The court relied on the last sentence of [N.I.L.] section 50, but clearly overlooked the fact that by [N.I.L.] section 66 the warranty runs to all subsequent holders in due course."  

Perhaps the only justification for the court's conclusion is that X might not have been a holder and, therefore, could not have been a holder in due course. Under the N.I.L., X had to be a holder in due course in order to take advantage of B's warranty.

Section 3-307(2)

Section 3-307 provides:


(2) When signatures are admitted or established, production of the instrument entitles a holder to recover on it unless the defendant establishes a defense.

This section gives a holder a presumption of ownership when he seeks payment. If a holder had to prove his ownership fully, negotiable instruments would not be widely used. Although the nonholder presentor "must prove his right to...[the instrument] and account for the absence of any necessary indorsement," this burden would not prove onerous to any payor. The payor could cancel and thus become a holder, or if this were not possible, he could prove his right to payment by producing the signed receipt that he received from his presentor. A problem might arise if the presentor had merely been a donee-transferee of a holder and not a holder in his own right. Whatever proof was sufficient to convince the payor to pay the presentor, however, should also be sufficient when the payor seeks payment. If the presentor proved his rights in court or by correspondence from his transferor, the payor will suffer

150 See N.I.L. § 23. Perhaps a purchaser from a reacquirer could take free of any defects in the title of the transferor of the reacquirer, i.e., the reacquirer is put back in the same position as he would have been if he had not originally negotiated the instrument. However, this result is not clear from N.I.L. § 50. Cf. N.I.L. § 121. If the above analysis is correct, such purchaser would not need any warranties from intervening parties.
151 N.I.L. § 66; cf. U.C.C. § 3-417(2), under which X would need to be a holder in order to sue B for breach of B's transfer warranties.
152 U.C.C. § 3-201(3).
153 U.C.C. § 3-307, comment 2.
154 Accommodation indorsers cannot cancel and thus become holders. U.C.C. § 3-415(1).
155 U.C.C. § 3-505(1)(d). See also U.C.C. §§ 3-413(1), (2), -414(1), -415(5), and note 25 supra.
156 U.C.C. § 3-201(3) does not give a donee the right to demand his transferor's indorsement.
little inconvenience by not being a holder. Furthermore, an accommodation indorser, for example, is obligated after dishonor to pay either a holder or someone with a holder's rights. Even if the accommodation indorser could demand his presentor's indorsement, he may not be a holder since his indorser might not be a holder. Unless section 3-201(3) is amended to allow a transferee or payor to demand any transferor's signature necessary to make the transferee or payor a holder, this problem will continue.\footnote{\textsuperscript{157}}

A maker seeks no further payment and thus does not need to be a holder. If a drawer seeks payment against an acceptor, he needs the rights of a holder.\footnote{\textsuperscript{158}} Thus, section 3-603(2) is necessary for him. A drawer could not seek payment from any other party. To charge the drawer's account, a drawee or an acceptor need not be a holder.\footnote{\textsuperscript{159}} An indorser has a right to recover from a prior indorser\footnote{\textsuperscript{160}} or a drawer without being a holder, but he would have to be a holder to recover from an acceptor or a maker.\footnote{\textsuperscript{161}} Thus, an indorser would need section 3-603(2).

An accommodation maker or an accommodation drawer can recover from the party accommodated without being a holder.\footnote{\textsuperscript{162}} An accommodation indorser who seeks payment from the drawer or an indorser prior to the one he accommodated would probably be considered an indorser\footnote{\textsuperscript{163}} and thus not need to be a holder.\footnote{\textsuperscript{164}} However, if a stranger seeks payment from a maker, an acceptor, a drawer, or an indorser,\footnote{\textsuperscript{165}} he must be a holder or their engagement does not run to him. Since there is no reason for a stranger either to bear the ultimate liability or to be forced to sue "off the instrument," section 3-603(2) appropriately allows him to become a holder.

Section 3-406

Section 3-406 provides:

Any person who by his negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorized signature is precluded from asserting the alteration or lack of authority against a holder in due course or against a drawee or other payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business.

\footnote{\textsuperscript{157} Such an amendment would be unfair if it \textit{required} the donor to give warranties, something he might not wish to do. An indorsement without recourse would not give the donor sufficient protection. U.C.C. \textsection{3-417}(3). Perhaps a mechanism could be devised to allow a holder to convert "order" paper into "blank" paper without his indorsement. Alternatively, a donor might be allowed to substitute his donee's name for his as payee of the special indorsement.\textsuperscript{158} See note 25 \textit{supra}.
\textsuperscript{159} U.C.C. \textsection{4-401}.
\textsuperscript{160} U.C.C. \textsection{3-414}(1).
\textsuperscript{161} U.C.C. \textsection{3-413}(2).
\textsuperscript{162} See note 25 \textit{supra}, for an analysis of U.C.C. \textsection{3-413}(1).
\textsuperscript{163} U.C.C. \textsection{3-415}(5).
\textsuperscript{164} See U.C.C. \textsection{3-415}(2), -402.
\textsuperscript{165} U.C.C. \textsection{3-413}(2), -414(1).
\textsuperscript{166} See note 25 \textit{supra}, for an analysis of U.C.C. \textsection{3-413}(1).
\textsuperscript{167} U.C.C. \textsection{3-415}(2).
\textsuperscript{168} U.C.C. \textsection{3-414}(1).}
This section is aimed at the situation where the normal rules regulating unauthorized signatures and material alterations are considered inappropriate either for equitable reasons or because of the need to regulate conduct. Thus, holders in due course and payors who paid "in good faith and in accordance with the reasonable commercial standards of the ... payor's business" are protected from an assertion of alteration or lack of authority by a "person whose negligence substantially contributed" to the alteration or unauthorized signature. The problem to be considered is whether a payor should be able to be a holder in due course for purposes of this section if he does not satisfy the "reasonable commercial standards" payor test.

If a person who would otherwise qualify as a holder in due course held a note through a forged indorsement, he would be allowed under section 3-406 to enjoy the rights of a holder in due course if the improper indorsement had been caused by the negligence of the person whose name was signed. Thus, such party could force a reluctant maker to pay the instrument upon presentment. If the person whose indorsement was forged sues the maker in conversion, the maker would set up section 3-406 by way of defense. If the maker, in accordance with the reasonable commercial standards of his business, he would win. If he had failed to act in accordance with those standards, he would argue that he should still be protected since he would have had to pay the presenter even if he had made all possible investigations. However, this argument ignores the possibility that if the maker had made reasonable commercial investigations the forgery might have been discovered sooner; and if the forgery had been discovered early enough, the person who would otherwise have to bear the ultimate loss, that is, the person whose indorsement was forged because of his own negligence, might have been able to find the forger and recover against him. Although this argument is not usually borne out by the facts, it might occasionally be correct. Since reasonable investigations do not put an unreasonable burden on the maker, he should be required to satisfy the reasonable payor test before he acquires the benefits provided by section 3-406. This approach establishes a form of contributory negligence and is consistent with the rationale of section 3-406. Thus, section 3-603(2) errs in

169 U.C.C. § 3-404(1).
170 U.C.C. § 3-407.
171 Although normally the only difference between a holder in due course and a payor who satisfies the payor test is that the payor has notice of a dishonor and thus cannot be a holder in due course in his own right, at times the differences may be greater. For a case in which such differences might be relevant, see Gresham State Bank v. OK Constr. Co., 231 Or. 106, 370 P.2d 726, aff'd, 231 Or. 106, 372 P.2d 187 (1962).
172 U.C.C. § 3-404(1) states that an "unauthorized signature is wholly inoperative as that of the person whose name is signed unless he is ... precluded from denying it." (Emphasis added.) Thus the otherwise holder in due course, referred to in the text, could not be a holder, let alone a holder in due course, unless the person whose name had been forged is precluded from asserting the forgery of his signature. However, if such preclusion occurs, the otherwise holder in due course, by negative inference from § 3-404(1), could be a holder and, by hypothesis, a holder in due course. The preclusion in the hypothetical discussed in the text is established by U.C.C. § 3-406.
173 See U.C.C. §§ 3-413(1), 305.
174 U.C.C. § 3-419(1)(c).
175 It should be noted that there is no causation between the maker's negligence and the forgery.
giving the payor the rights of his presentor.\(^{176}\) The same considerations would apply to a drawer and a drawee. With regard to the drawee, however, this analysis might be somewhat modified by section 4-407, which gives the drawee whose payment is improper as against the drawer or maker the rights "of any . . . holder in due course on the item against the drawer or maker." Thus, if the drawer's signature were forged to a draft because of the drawer's negligence, a drawee who paid a holder in due course would probably be able to charge the drawer's account even if such action did not follow reasonable commercial standards: The only possible reconciliation of sections 3-406 and 4-407 is that the latter was designed "to prevent unjust enrichment." It could be argued that if the drawee did not act in a reasonable commercial manner, it would be unjustly enriched by its charge to the drawer's account.

A different problem arises with an indorser-payor. Suppose that \(A\) issues a check to \(B\), \(B\) specially indorses the instrument to \(C\), and \(C\)'s special indorsement to \(D\) is forged through \(C\)'s negligence. \(D\) presents the check to the drawee who dishonors it. \(D\) then presents the check to \(B\), who pays. When \(C\) sues \(B\) in conversion,\(^{177}\) \(B\) would assert section 3-406 as a defense. If \(B\) satisfied the payor test, he would be successful. On the other hand, if \(B\), previously a holder in due course, did not make reasonable investigations before paying, he would argue that section 3-406 favors all holders in due course since it does not distinguish between holders in due course before the alteration or unauthorized indorsement and after. Such a distinction, however, would be consistent with the rationale of section 3-406. The drafters probably did not draw that distinction because they contemplated that a holder in due course before the alteration or unauthorized indorsement who subsequently paid the instrument would be judged by the payor standard. Such an approach is more consistent with the theory of section 3-406. Moreover, section 3-406 speaks of a person who is a holder in due course, and if the indorser paid, he would no longer be a holder in due course in his own right.\(^{178}\) Even if the indorser had been a holder in due course after the alteration or unauthorized indorsement, he should be judged by the payor standard. He is a payor and should order his conduct accordingly. Section 3-406 was in part designed to provide a method by which proper conduct is rewarded. Furthermore, the equities between two careless people are not as clear as those between a negligent person and a person who acts properly. Normally, where two people act improperly and one is injured because of the improper conduct of the other, the law lets the damage lie where it falls.

A stranger could become a holder in due course in his own right.\(^ {179}\) However, since he is a payor, it seems more appropriate to judge him by the payor standard than to give him the benefit of other standards with which he com-

\(^{176}\) It has been suggested that the shelter principle is inconsistent with the negligence rationale. See Note, Allocation of Losses from Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code, 62 Yale L.J. 417, 462 (1953). If the shelter principle is used, would a party who was a holder in due course when he originally held the instrument obtain the rights of a holder in due course if he paid the forger or his accomplice? See ibid.

\(^{177}\) U.C.C. § 3-419(1)(c).

\(^{178}\) U.C.C. § 3-302(1)(c).

\(^{179}\) See notes 40 and 41 supra.
plies. This consideration also applies to other payors who can be holders in due course in their own rights. For the reasons previously considered, all accommodation parties should also be held to the payor standard. Thus, with regard to section 3-406, section 3-603(2) is not appropriate for any payor.

Section 3-407

Section 3-407 provides:

1. Any alteration of an instrument is material which changes the contract of any party thereto in any respect, including any such change in
   (a) the number or relations of the parties; or
   (b) an incomplete instrument, by completing it otherwise than as authorized; or
   (c) the writing as signed, by adding to it or by removing any part of it.

2. As against any person other than a subsequent holder in due course
   (a) alteration by the holder which is both fraudulent and material discharges any party whose contract is thereby changed unless that party assents or is precluded from asserting the defense;
   (b) no other alteration discharges any party and the instrument may be enforced according to its original tenor, or as to incomplete instruments according to the authority given.

3. A subsequent holder in due course may in all cases enforce the instrument according to its original tenor, and when an incomplete instrument has been completed, he may enforce it as completed.

This section defines a material alteration and attempts equitably to allocate any losses resulting from such alteration. It is probably based on a theory of "comparative innocence." Thus, an altered instrument is only enforceable according to its original tenor, but an incomplete instrument is enforceable by a holder in due course as completed. An alterer is prevented from enforcing the instrument.

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180 This could only happen if a maker-payor who pays a note at maturity does not have notice that the note is overdue. It also assumes that a drawee paying a check on presentment does not have notice that the check is overdue. U.C.C. § 3-502(1)(c).

181 But cf. N.I.L. § 124, which gives a nonholder in due course no rights on the altered instrument against the maker, drawer, or prealteration indorsers. This approach seems too harsh since the maker or drawer of the instrument might have received goods in return for the instrument, and he would be unjustly enriched if the holder could not bring a claim for the original amount of the instrument. Such claim could be brought pursuant to N.I.L. § 196, but it would be an action off the instrument and thus would be more inconvenient and more expensive for the holder. If the maker or drawer had originally given the instrument as a gift, the nonholder in due course might not have rights to any money. For example, suppose that A gave B a $100, thirty-day bearer note, C defrauded B into transferring the note to him, altered the amount from $100 to $1000, and transferred it for value to D after maturity. D would have no rights on or off the instrument against either A or B.

182 U.C.C. § 3-407(2)(a). The term "holder" is ambiguous. It is not clear whether this term refers to any holder or just a holder at the time presentment is made and the defense is asserted. Even if the former approach is taken, the resulting discharge would not be binding against subsequent holders in due course without knowledge of the discharge when they took. U.C.C. § 3-602. However, it would be binding against subsequent nonholders in due course. This approach seems to go beyond the purpose of § 3-407(2)(a), which is to penalize the alterer. This problem was raised in Steinhammer, Impact of the Commercial Code on Liability of Parties to Negotiable Instruments in Michigan, 53 Mich. L. Rev. 171, 185 (1954). Perhaps "holder" is not the exact term intended by the drafters. Any alterer who
Since neither a maker nor a drawer of an unaccepted draft can enforce the instrument against another party, neither need be a holder in due course. If the drawer of an accepted instrument pays a holder in due course, it seems reasonable to allow him to enforce the instrument pursuant to his payee's rights. This right would be relevant only if an incomplete instrument had been completed requiring the drawer to pay an amount in excess of that originally authorized. Upon acceptance, the drawee would have charged the excessive amount to the drawer's account and be unjustly enriched if the drawer could not claim such amount. Thus, section 3-603(2) seems appropriate here.

A drawee does not need to be a holder in due course since section 4-401(2) permits him to "enforce" the instrument with the same rights as a holder in due course. However, there is some slippage between sections 3-407 and 4-401(2). If a holder fraudulently and materially altered an instrument before seeking payment, the intended payor would be discharged against all but subsequent holders in due course. However, if a drawee altered the instrument after payment but before charging the drawer's account, the drawee, if his alteration were discovered, could still charge the drawer's account for the unaltered amount. The drawee can make this charge because section 4-401(2) speaks only of the drawee making the payment in good faith. It does not require the drawee to make the charge in good faith. There is no reason for the drawee, in this situation, to be treated differently than the holder.

An indorser who had materially and fraudulently altered an instrument when he originally held it should not be able to improve his position upon his payment. Section 3-603(2) achieves the correct result since it refers to section 3-201(1), which prohibits a "party to any fraud . . . affecting the instrument" to improve his position upon reacquisition. An indorser who originally took the instrument after the alteration and who was, at that time, a holder in due course should be protected if he pays the alterer. However, section 3-603(2) is ambiguous on this point. The U.C.C. states that once a holder in due course has taken the instrument, all subsequent takers, under the shelter principle, have the rights of holders in due course unless they were parties to a fraud or illegality affecting the instrument or were prior holders who had notice of a claim or defense. It could be argued that when such a taker acquires the instrument, the shelter still exists but it is subject to defenses personal to the particular taker. Then, when such taker transfers the instrument, the shelter remains for the innocent transferee's benefit.

later becomes a holder would seem to fall within the "evil" contemplated. A donee-transferee-nonholder who alters and then presents would also seem to fit within the evil. U.C.C. § 3-201(1) gives him the rights of a holder, but it does not speak of giving him a holder's liabilities.

183 The completion would probably have had to occur prior to acceptance or the drawee would not have accepted.
184 U.C.C. §§ 3-407(2)(a), (3).
185 U.C.C. § 3-603(2) refers to U.C.C. § 3-201(1).
186 It is not clear from the language of U.C.C. § 3-201(1) that a party to a fraud or illegality affecting the instrument who was not a prior possessor of the instrument cannot get the rights of his transferee-holder in due course through the shelter principle. Section 3-201(1) speaks of "[improving] his position." This would seem to imply that at some past time he was a possessor of the instrument. Perhaps a gloss would have to be developed to prevent a defrauder's accomplice from getting the rights of a holder in due course.
This argument, however, seems contrary to the language of the statute. The U.C.C. states, “Transfer of an instrument vests in the transferee such rights as the transferor has therein.”[187] (Emphasis added.) No distinction is drawn for rights subject to defenses personal to the transferor. Since the purpose of the shelter principle is to protect the market of the holder in due course after the fraud or illegality becomes known, the shelter principle would not be necessary after the wrongdoer acquired the instrument since there would be no reason to protect his market. It might be argued that if the fraud and the fraudulent parties are not well known, this latter approach places an unreasonable burden on purchasers. However, there is no reason why a purchaser should not become a holder in due course in his own right or be treated accordingly.

This answer, however, would not apply to an indorser-payor who paid after maturity and thus could not become a holder in due course in his own right. It would seem reasonable to have a special rule for him. Perhaps a distinction should be drawn for an indorser who had been a holder in due course before the alteration and who now pays the altered instrument without either protesting the alteration or establishing that his presentor is not the alterer. Such an indorser-payor would seem not to have great equities and might have helped the alterer escape. Again, it is not clear whether this distinction is drawn under section 3-603(2) since that section refers to section 3-201(1), which deprives only a party to the fraud or a person “who as a prior holder had notice of a defense or claim” from attaining the rights of a holder in due course. Since the indorser-payor had nothing to do with the alteration, he would probably not be held a party to the fraud.

The “prior holder” exception can be interpreted in two ways. First, it could refer to a prior holder who, when he was a prior holder, had notice of a claim or defense and thus could not be a holder in due course. Secondly, it could refer to a prior holder who, because of his prior holding, now has notice of a claim or defense.[188] Under the latter interpretation, the prior holder could have been a holder in due course during his original holding. If he were, it would not make sense to speak of him as improving his position by taking from a subsequent holder in due course. Thus, the first interpretation is probably correct.

A stranger-payor who alters the instrument and then presents it to the appropriate payor clearly fits within the policy of section 3-407(2)(a). Section 3-603(2) would help reach the appropriate result, but might not be necessary.[189] If the stranger did not pay a holder in due course, section 3-603(2) would help the stranger become one in his own right.

If an accommodation party accommodated before the alteration and,
therefore, should have realized that there had been an alteration paid without
either ascertaining that his presentor was not the alterer or protesting the altera-
tion, a discussion of the indorser-payor who had held before the alteration
would be relevant. Otherwise, there is no reason why an accommodation party
should not have the full benefit of the shelter provision. It would also be
proper to allow the accommodation maker to become a holder in due course
in his own right, although it is not clear that he can under the Code.

Section 3-411(1)

Section 3-411 provides:
(1) Certification of a check is acceptance. Where a holder procures
certification the drawer and all prior indorsers are discharged.

This section explains who is discharged if a holder obtains certification of
a check. It distinguishes between a drawer and a holder on the theory that
the drawer only engages that the check will be paid on presentment. Thus,
when a holder chooses to tie up the drawer’s credit without accepting payment,
the drawer would, in effect, be facing an unconsented, double risk if he were
not discharged. For example, assume that the drawee, after certification pro-
cured by the holder, suspends payments, the holder then presents the check
to the drawee for payment, and the drawee dishonors. If the drawer was still
liable, he would bear the risk of the drawee’s potential insolvency with regard
to both his own money and the holder’s. This result would be unfair. Furthe-
more, if the drawee refused to certify the check, the check would be dishonored,
and the holder-presentor could go against the drawer in the same manner as
if he had presented the check for payment and the drawee had dishonored.

Therefore, the U.C.C. establishes the rule that a holder who obtains certifica-
tion of a check has accepted a novation. If the drawer ties up his own credit
by obtaining certification, however, he is treated as having changed his engage-
ment and continues to be bound. This approach, first taken under the N.I.L.,
appears to be inconsistent with commercial reality. “Certified checks are nor-
mally taken on the credit of the bank alone, and the party who obtains certifica-
tion is often a matter of pure accident, depending upon who may be near the
bank or have the time available.” Thus, in the Proposed Final Draft of

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190 See the discussion in the text as to whether a former holder in due course who paid
the defrauder would get the rights of a holder in due course.
191 See note 136 supra.
192 U.C.C. § 3-411, comment 1.
193 The contract made by the drawer of a check is that it will be paid on presentment,
if presented within a reasonable time but not that it will be certified by the drawee,
and therefore, when the payee or other holder or owner of a check, instead of
demanding payment procures its certification by the drawee, the drawer’s credit
deposit with drawee is, to the extent of the check, taken from his control and
appropriated to the payment of the check, and that is the theory on which the law
discharging the drawer and any indorsers is based. Lipton v. Columbia Trust Co.,
195 U.C.G. § 4-104(1)(k).
196 U.C.G. § 3-507(1)(a).
197 U.C.G. § 3-413(2).
198 N.I.L. § 188.
the U.C.G., certification obtained by anybody discharged all parties unless the drawer was also an indorser, in which case his indorsement still remained valid. However, when the 1952 Code was drafted, the N.I.L. approach was retained.

All payors except drawers and accommodation drawers — that is, indorsers, strangers, and accommodation indorsers — would seem to fit within the holder's choice rationale. Thus, they should be holders for purposes of section 3-411(1). Section 3-603(2) would accomplish this result either by giving them the rights of a holder or by allowing them to become a holder. However, it is not clear that a drawer-payor should be a “holder” for purposes of section 3-411(1) since allowing him to become one would undermine the rationale for the drafter's implied distinction between holder and drawer. Thus, section 3-603(2), which would allow him to be a holder, appears to be inconsistent with section 3-411(1).

A different problem exists where the accommodation drawer seeks certification. Since all people without notice of his accommodation nature would confuse the accommodation drawer with the drawer, those who realized that the accommodation drawer obtained certification might assume that he is still liable and order their affairs accordingly. A distinction could be drawn here between takers after certification who are holders in due course and those who are not. Section 3-415(3) allows accommodation parties to introduce oral proof of the accommodation against all parties except holders in due course without knowledge of their accommodation character and thus take advantage of all discharges dependent on the accommodation party’s accommodation character. Since an accommodation drawer is neither a drawer to the party accommodated, nor a holder in due course with notice of the accommodation, nor a nonholder in due course, he could be given a discharge “dependent on his character as” an accommodation party. In other words, if it were not for his accommodation character, he would be a drawer and not entitled to be discharged. However, such view seems unfair to the innocent takers. Thus, section 3-603(2) seems inappropriate here.

Section 3-416

Section 3-416 provides:

(1) “Payment guaranteed” or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor without resort by the holder to any other party.

200 U.C.G. § 3-201(1).
201 U.C.G. § 3-201(3).
202 It should be noted that a drawer could be the payee of a check. U.C.G. § 3-110(1)(a). As such, he would be a holder. U.C.G. § 1-201(20).
203 It is unlikely that the drawer would want to certify an already dishonored check since such a check would cast aspersions on his credit. If he did want certification, possibly to prove that the drawee dishonored by mistake, he would either have to have his presentor seek the certification or have a dummy do it for him.
204 There would be no holders in due course if the dishonor were noted on the check. U.C.G. § 3-302(1)(c).
205 U.C.G. § 3-415(3).
(2) "Collection guaranteed" or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor, but only after the holder has reduced his claim against the maker or acceptor to judgment and execution has been returned unsatisfied, or after the maker or acceptor has become insolvent or it is otherwise apparent that it is useless to proceed against him.

(3) Words of guaranty which do not otherwise specify guarantee payment.

(4) No words of guaranty added to the signature of a sole maker or acceptor affect his liability on the instrument. Such words added to the signature of one of two or more makers or acceptors create a presumption that the signature is for the accommodation of the others.

(5) When words of guaranty are used presentment, notice of dishonor and protest are not necessary to charge the user.

(6) Any guaranty written on the instrument is enforcible notwithstanding any statute of frauds.

This section defines the rights of a holder vis-à-vis various types of guarantors. Basically, the guarantors are divided into two types: "guarantors of payment" and "guarantors of collection." A guarantor of payment engages that he will pay the instrument when due, regardless of any prior presentments or the lack thereof. In effect, as to the holder, the guarantor is primarily liable.

Thus, if a holder obtained payment from an indorser after dishonor, the indorser should have rights against the guarantor. Section 3-603(2) would give him such rights. Similarly, if a draft were accepted and a drawer paid, section 3-603(2) would give him rights against any guarantor of payment who gave his guarantee after the acceptance. This result seems appropriate unless a reliance analysis is used, since the guarantor was in effect a co-acceptor and the drawer would have rights against the acceptor. It is debatable, however, whether a drawer should have rights against a guarantor who gave his guarantee before acceptance since such guarantee might refer to either the drawee or the drawer. If the guarantee referred to the drawer, it would be strange to allow the drawer to take advantage of it. Section 3-603(2) does not make such a distinction.

A guarantor of collection engages that the maker or acceptor will ultimately pay the instrument. Thus, section 3-603(2) would give any payor having rights against either the maker or the acceptor the use of this guarantee. This result is proper unless a reliance analysis is used because it does not increase the guarantor's liability.

Sections 3-417 and 4-207

Section 3-417 provides:

(1) Any person who obtains payment or acceptance and any prior transferor warrants to a person who in good faith pays or accepts that

(a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title; and

(b) he has no knowledge that the signature of the maker or drawer

206 U.C.C. § 3-416, comment, ¶ 2.
207 See the discussion of § 3-112(1)(b) supra.
208 Ibid.
is unauthorized, 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 drawee; or
   (iii) to an acceptor of a draft if the holder in due course took the draft after the acceptance or obtained the acceptance without knowledge that the drawer's signature was unauthorized; and

(c) the instrument has not been materially altered, except that this warranty is not given by a holder in due course acting in good faith
   (i) to the maker of a note; or
   (ii) to the drawer of a draft whether or not the drawer is also the drawee; or
   (iii) to the acceptor of a draft with respect to an alteration made prior to the acceptance if the holder in due course took the draft after the acceptance, even though the acceptance provided "payable as originally drawn" or equivalent terms; or
   (iv) to the acceptor of a draft with respect to an alteration made after the acceptance.

(2) Any person who transfers an instrument and receives consideration warrants to his transferee and if the transfer is by indorsement to any subsequent holder who takes the instrument in good faith that
   (a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title and the transfer is otherwise rightful; and
   (b) all signatures are genuine or authorized; and
   (c) the instrument has not been materially altered; and
   (d) no defense of any party is good against him; and
   (e) he has no knowledge of any insolvency proceeding instituted with respect to the maker or acceptor or the drawer of an unaccepted instrument.

(3) By transferring "without recourse" the transferor limits the obligation stated in subsection (2) (d) to a warranty that he has no knowledge of such a defense.

(4) A selling agent or broker who does not disclose the fact that he is acting only as such gives the warranties provided in this section, but if he makes such disclosure warrants only his good faith and authority.

Section 4-207 provides:
(1) Each customer or collecting bank who obtains payment or acceptance of an item and each prior customer and collecting bank warrants to the payor bank or other payor who in good faith pays or accepts the item that
   (a) he has a good title to the item or is authorized to obtain payment or acceptance on behalf of one who has a good title; and
   (b) he has no knowledge that the signature of the maker or drawer is unauthorized, except that this warranty is not given by any customer or collecting bank that is a holder in due course and acts 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 drawee; or
      (iii) to an acceptor of an item if the holder in due course took
the item after the acceptance or obtained the acceptance without knowledge that the drawer's signature was unauthorized; and

(c) the item has not been materially altered, except that this warranty is not given by any customer or collecting bank that is a holder in due course and acts in good faith

(i) to the maker of a note; or

(ii) to the drawer of a draft whether or not the drawer is also the drawee; or

(iii) to the acceptor of an item with respect to an alteration made prior to the acceptance if the holder in due course took the item after the acceptance, even though the acceptance provided "payable as originally drawn" or equivalent terms; or

(iv) to the acceptor of an item with respect to an alteration made after the acceptance.

(2) Each customer and collecting bank who transfers an item and receives a settlement or other consideration for it warrants to his transferee and to any subsequent collecting bank who takes the item in good faith that

(a) he has a good title to the item or is authorized to obtain payment or acceptance on behalf of one who has a good title and the transfer is otherwise rightful; and

(b) all signatures are genuine or authorized; and

(c) the item has not been materially altered; and

(d) no defense of any party is good against him; and

(e) he has no knowledge of any insolvency proceeding instituted with respect to the maker or acceptor or the drawer of an unaccepted item.

In addition each customer and collecting bank so transferring an item and receiving a settlement or other consideration engages that upon dishonor and any necessary notice of dishonor and protest he will take up the item.

(3) The warranties and the engagement to honor set forth in the two preceding subsections arise notwithstanding the absence of indorsement or words of guaranty or warranty in the transfer or presentment and a collecting bank remains liable for their breach despite remittance to its transferor. Damages for breach of such warranties or engagement to honor shall not exceed the consideration received by the customer or collecting bank responsible plus finance charges and expenses related to the item, if any.

(4) Unless a claim for breach of warranty under this section is made within a reasonable time after the person claiming learns of the breach, the person liable is discharged to the extent of any loss caused by the delay in making claim.

The presentment warranties serve two functions. First, they put the loss or risk of loss on the "most guilty" party — the wrongdoer or the person who dealt with the wrongdoer. The Code accomplishes this by giving a payor rights against a presentor who does not have good title or who seeks full payment of an altered instrument. In addition, presentment warranties place the loss on the party with either the "deepest pocket" or the best opportunity to spread the loss ratably. This function is served when a drawee who pays over the drawer's forged signature is denied any rights against his presentor.209 Because section

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209 Strictly speaking, the warranty did not cause this result, the limitation on the warranty did. See U.C.C. § 3-417(1)(b).
3-603(2) might be interpreted as giving the payor transfer warranties,\textsuperscript{210} the appropriateness of this result must be considered.

Since the maker should recognize his own signature or realize that it was unauthorized, giving him transfer warranties is undesirable.\textsuperscript{211} If he is not careful enough to make these observations, he is less innocent than a presentor or prior transferee who is a holder in due course and had no notice of the unauthorized or forged signature when he presented or negotiated the instrument.\textsuperscript{212} Thus, to give the maker the transfer warranty that “all signatures are genuine or authorized” would condone lax behavior and lead to unfair results.

The maker does not need the presentor’s warranty that he has no knowledge of any insolvency proceeding\textsuperscript{213} instituted against the maker. The purpose of this warranty is to prevent the concealment of insolvency proceedings against the party who is expected to pay since “the concealment of that fact amounts to a fraud upon the buyer.”\textsuperscript{214} Clearly, the maker would know of any proceedings instituted against him. In addition, he is obligated to pay the instrument\textsuperscript{215} and is not being deceived into purchasing an instrument that he would not otherwise want.

Finally, the maker does not need the presentor’s warranty that no defenses of any party are “good” against him (the presentor) because such defenses would only be relevant if the taker had to seek further payment. Since the maker has the ultimate liability on a note, the fact that any defenses are good against the presentor would be irrelevant to him.

These considerations would also apply to a drawer-payor unless the instrument had been accepted. If the instrument had been accepted, the drawer would not bear the ultimate liability on it; rather, the acceptor would. Neither such drawer nor any other payor not bearing the ultimate liability would want to pay an instrument he did not have to pay and could not enforce against the acceptor.\textsuperscript{216} There are probably two reasons why the draftsmen did not give payors the transferor’s warranty that “no defenses of any party are good against him.”\textsuperscript{217} First, this transfer warranty was designed to protect a buyer from purchasing “a lawsuit with the necessity of proving his status.”\textsuperscript{218} Thus, even a holder in due course could be held on this warranty. For example, if A issued

\textsuperscript{210} U.C.C. § 3-603(2) gives the payor the rights of a transferee. However, § 3-201 is used in opposition to “rights of a transferee.” Thus, it might be argued that these transferee rights are restricted to rights on the instrument and do not include rights to the transfer warranties.

\textsuperscript{211} It must be remembered that the maker has presentment warranties, U.C.C. § 3-417(1), which overlap the transfer warranties, U.C.C. § 3-417(2). Thus, a maker is protected from an unauthorized indorsement. U.C.C. § 3-417(1)(a).

\textsuperscript{212} U.C.C. §§ 3-417(1)(b), 1-201(19). Perhaps even the requirement that the presentor or prior transferor-holder in due course must not know of the forgery when he presents or negotiates is too strict. Maybe lack of knowledge when he first took should be sufficient although such approach would allow a prior transferor who learned of the forged signature after taking the instrument to continue to pass the instrument even though he realized that it was invalid. \textit{But cf.} U.C.C. § 3-417(2)(b). Such continued passing would be a form of fraud.

\textsuperscript{213} U.C.C. § 1-201(22).

\textsuperscript{214} U.C.C. § 3-417, comment 10.

\textsuperscript{215} U.C.C. § 3-413(1).

\textsuperscript{216} See note 25 \textit{supra}.

\textsuperscript{217} U.C.C. § 3-417(2)(d).

\textsuperscript{218} U.C.C. § 3-417, comment 9.
a note to B on the basis of B’s fraudulent promises, and B negotiated the note to C, a holder in due course, and C negotiated the note to D, if D presented the note to A and A would not pay until D proved that he was a holder in due course, D could sue C for breach of warranty. However, it would not be proper to give a payor such rights against a holder in due course because the payor is obligated to pay the holder in due course even if he knew of the defense. The buyer might not have bought the instrument if he knew of the problems entailed in its collection. This problem could have been avoided merely by phrasing the presentment warranty: “No defense is good against him.” Second, the drafters might only have envisioned a situation in which any defense good against the presenter was also good against the payor when he originally held. Thus, if the payor could sue the presenter for breach of warranty, the presenter could sue the payor for breach of warranty, and a circularity of rights would be created. For example, A issued a note to B on the basis of B’s fraudulent promises, and B negotiated the note after maturity to C, a nonholder in due course. If A dishonors, B pays C and then sues C on C’s breach of warranty, C could counterclaim against B on B’s breach of warranty. However, this situation would not occur with regard to the drawer-payor. Thus, there is no reason why the drawer should not be given the benefit of this warranty.

Even with regard to an indorser-payor, the circularity problem need not occur. For example, A could issue a draft to B, who negotiates it to C. C is induced by fraud to negotiate the draft to D. D negotiates the instrument after maturity to E. E presents the draft to the drawee, who dishonors. E then presents the draft to B, who pays. Assuming that B and C are donees, when B presents to A, A could interplead C, thereby allowing C to assert his claim. Thus, the indorser should also be given the benefit of the warranty. However, an indorser-payor should bear the risk of a maker or drawer’s forged signature because the indorser helped lull the presentor into believing that the instrument was valid. Similarly, the indorser should not receive the “insolvency proceeding” warranty. One of the reasons for making indorsers liable on the instrument is to protect a later holder from the maker’s insolvency. The indorser relied on the maker’s credit when he took the instrument and later takers relied on the indorser’s credit. Such reliance on the indorser’s credit is not unreasonable since the indorser receives the benefit of having a ready market when he seeks to dispose of the instrument. It is also helpful in making negotiable instruments more acceptable and causes no evidence problem. The same considerations apply to accommodation parties.

It is arguable whether the drawee should have one of the transfer warranties. If a drawee pays a draft bearing an unauthorized signature of the drawer,

219 This assumption avoids the question of whether a payor who was a holder in due course when he originally held but who paid a nonholder in due course regains the rights of a holder in due course upon repossession of the instrument.
220 A could not raise C’s claim for him. U.C.C. § 3-306(d); see also U.C.C. §§ 3-603(1)-306, comment 5.
221 U.C.C. § 3-414(1).
222 See Fuller, Basic Contract Law 580-82 (1947), for a discussion of the importance of negotiable instruments to a nation’s economy.
223 The warranties received by a drawee are determined under U.C.C. § 4-207(1) rather than U.C.C. § 3-417(1). However, these two sections are identical.
several reasons have been proffered to prevent the drawee from having rights against a presentor who had no knowledge that the signature was unauthorized. Traditionally, it was thought that the drawee should recognize the drawer's signature. Thus, if the drawee did not realize that the drawer's signature was forged, he was careless and thereby "less innocent" than the presentor. More recently, drawees' rights against presentors have been denied on two grounds: (1) that drawees are in a better position to spread the loss since they deal in bulk and are more likely to insure, and (2) that banks will thus be encouraged to exercise greater caution in dealing with signatures with which they should be familiar. Although none of these reasons is completely convincing, a legislative judgment to end the transaction upon the drawee's payment is not unreasonable.

However, a legislative judgment not to give the drawee a warranty like that given in section 3-417(2)(c) is unreasonable. The drawee should be given notice of any insolvency proceedings instituted against the drawer. Certain bankruptcy consequences of the drawee's actions are dependent upon facts that the drawee knows or should know, but the drawee often does not receive timely notice of the proceedings. Moreover, if there are insufficient funds in the drawer's account to cover the amount of the check, and the drawee pays the check, the drawee, in effect, has loaned money to the drawer. Since the drawee is not obligated to do this, the concealment of insolvency proceedings from him would seem to be fraudulent.

The drawee does not need the "defense" warranty because he can "charge against . . . [the drawer's] account any item which is otherwise properly payable from that account." Although "properly payable" could mean either any item, regular on its face, that the drawee paid to a holder, or any item, regular on its face, that the drawee paid after asserting all possible defenses, the latter interpretation would be unduly harsh on the drawee and, therefore, unlikely. Thus, that defenses were good against the drawee's presentor would, after payment, be irrelevant to the drawee.

Section 3-419(1)

Section 3-419 provides:

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

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227 This is permitted by U.C.C. § 4-401(1).
228 U.C.C. § 3-409(1).
229 U.C.C. § 3-417(2)(d).
230 U.C.C. § 4-401(1).
This section speaks of certain acts that constitute conversion. It is not clear, however, who has the right to bring suit under the U.C.C. The language of section 3-419 does not appear to change the common-law rule that an action in conversion can be brought by the person who was in possession of the chattel at the time of the conversion. Comment 2 declares that a “negotiable instrument is the property of the holder,” but this statement is not always correct. For example, a thief can be the holder of blank paper, but he is not the owner. Perhaps comment 2 could be interpreted as an overstatement intended to indicate that section 3-419 creates a slight modification in the common-law rule. Under this interpretation, a possessor who held through a forged indorsement could not bring a section 3-419 action. However, a thief of bearer paper or a holder who induced his transferor to negotiate the instrument by a fraudulent promise could bring such action. This approach might not be what the drafters intended. Comment 3, which discusses section 3-419(c), speaks of “rights of the owner.” Under this approach, a thief could not bring a section 3-419 action, nor could a bailee who held bearer paper.

Another big problem in the common-law approach is the measure of damages, but the U.C.C. suggests no solution. Each jurisdiction has its own approach as to whether the possessor should recover the full value of the chattel or only the value of his interest. Since this is a problem that does not require uniformity, the drafters might not have intended to cover it.

There is no reason why all payors should not have the right under section 3-419 to bring suit at least to the extent that their presentor had such right. Of course, a payor might not need these rights. For example, a maker would not seek either acceptance or payment; thus, sections 3-419(1)(a) and 3-419(1)(b) are not necessary for him. However, no problem is created by the approach of section 3-603(2).

Sections 3-501 and 3-502

Section 3-501 provides:
(1) Unless excused (Section 3-511) presentment is necessary to charge secondary parties as follows:
(a) presentment for acceptance is necessary to charge the drawer and indorsers of a draft where the draft so provides, or is payable elsewhere than at the residence or place of business of the drawee, or its date of payment depends upon such presentment. The holder may at his option present for acceptance any other draft payable at a stated date;
(b) presentment for payment is necessary to charge any indorser;
(c) in the case of any drawer, the acceptor of a draft payable at

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232 See U.C.C. §§ 1-201(20), 3-603(1)(a).
233 But see Prosser, op. cit. supra note 231, at 95: “No court ever has allowed an admitted, or even a clearly proved, thief without claim of right to recover, and it seems improbable that one ever will.”
234 An interesting problem with regard to U.C.C. § 3-419(1)(c) is the question of what is meant by “forged indorsement.” An “unauthorized indorsement” would include a forged indorsement, U.C.C. § 1-201(43), but a forged indorsement need not logically mean an indorsement made without the authorization of the indorser. Another problem with regard to “forged indorsement” is whether the cancellation of indorsements by a thief or an unauthorized party in order to give the impression of a reacquisition is a “forged indorsement.”
a bank or the maker of a note payable at a bank, present-
ment for payment is necessary, but failure to make present-
ment discharges such drawer, acceptor or maker only as stated
in Section 3-502(1) (b).

(2) Unless excused (Section 3-511)
(a) notice of any dishonor is necessary to charge any indorser;
(b) in the case of any drawer, the acceptor of a draft payable at
a bank or the maker of a note payable at a bank, notice of
any dishonor is necessary, but failure to give such notice dis-
charges such drawer, acceptor or maker only as stated in
Section 3-502(1) (b).

(3) Unless excused (Section 3-511) protest of any dishonor is neces-
sary to charge the drawer and indorsers of any draft which on its face
appears to be drawn or payable outside of the states and territories of the
United States and the District of Columbia. The holder may at his option
make protest of any dishonor of any other instrument and in the case of a
foreign draft may on insolvency of the acceptor before maturity make
protest for better security.

(4) Notwithstanding any provision of this section, neither present-
ment nor notice of dishonor nor protest is necessary to charge an indorser
who has indorsed an instrument after maturity.

Section 3-502 provides:
(1) Where without excuse any necessary presentment or notice of
dishonor is delayed beyond the time when it is due
(a) any indorser is discharged; and
(b) any drawer or the acceptor of a draft payable at a bank or the
maker of a note payable at a bank who because the drawee or
payor bank becomes insolvent during the delay is deprived of
funds maintained with the drawee or payor bank to cover the
instrument may discharge his liability by written assignment
to the holder of his rights against the drawee or payor bank
in respect of such funds, but such drawer, acceptor or maker
is not otherwise discharged.

(2) Where without excuse a necessary protest is delayed beyond the
time when it is due any drawer or indorser is discharged.

These sections attempt to establish the steps necessary for a presentor to
charge a particular payor and the consequences if they are not followed in a
timely manner. As to the former, they are not entirely clear. Prior to the
1958 revision of the Code, presentment was defined as a demand for acceptance
or payment made upon the maker, acceptor, or drawee. Since section 3-501(1)
states that unless excused, presentment and notice of dishonor are necessary to
charge secondary parties, that is, demand must be made upon a maker,
drawee, or acceptor who refused payment before the drawer, indorser, accom-
modation indorser, or accommodation drawer could be charged.

Two problems concerning a payor arise under these sections. The first is
whether a section 3-502 discharge is good against a secondary party who pays

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235 See also U.C.G. §§ 3-413(1), (2), -414(1).
236 For a statement of what constitutes timely presentment, see U.C.C. § 3-503.
238 Indorsers, accommodation indorsers, drawers, and accommodation drawers are secondary
parties. U.C.G. § 3-102(1)(e); see also U.C.C. § 3-415(2).
the instrument. For example, suppose that A issues a check to B, who indorses it to C. C holds the check for four days and then indorses it to D. D holds the check for four days and then presents it to the drawee, who dishonors. D then waits for three days after the instrument is returned to him before he gives notice of the dishonor. At this point, B might be discharged vis-à-vis D, but C is not. When C pays the instrument, does he have rights against B? Section 3-603(2) provides that C takes the instrument with D's rights, and D has no right against B. This approach, however, causes C to lose the benefit of his surety through no fault of his own. This result seems unfair. Normally, C could argue that D had impaired C's right of recourse, and thus, C also should be discharged against D. However, section 3-606(1)(a), which deals with impairment of recourse, states that "failure or delay in effecting any required presentment... with respect to any... [person against whom C has, to the knowledge of the holder, a right or recourse] does not discharge any party as to whom presentment, protest or notice of dishonor is effective..." Therefore, C cannot hope to succeed with such an argument. He might argue that the test of whether presentment to B was made in a timely manner is whether the presentment was made "within a reasonable time after such party became liable thereon," and that such reasonable time varies as to the presentor. Thus, if immediately after C receives the instrument he demands payment from B, he should not be bound by D's delay. Acceptance of this argument, however, would create the undesirable result of forcing an indorser to stand behind an instrument for a lengthy period. Therefore, the section 3-603(2) approach should be adopted here.

The second problem is whether a payor, after paying and receiving the instrument, can delay too long and, therefore, discharge other secondary parties who had notice of the dishonor. If he can, a payor would be able to force other secondary parties to keep their money idle for lengthy periods, a result harmful to the economy. Section 3-508(3) states that notice of dishonor may be given in any reasonable manner, whether oral or written, and section 3-508(8) states that such notice operates for the benefit of all parties. Thus, the notice requirement of section 3-501 is satisfied as soon as the secondary party is told of the dishonor since no section speaks of such notice becoming stale.

Section 3-501 also speaks of presentment as being necessary to charge a secondary party, but presentment to whom is not clear. Conceivably, presentment to the dishonoring party is sufficient, but in 1958 the definition of "presentment" was amended to include a demand made to any payor. Perhaps this amendment was effected in order to clarify or change section 3-501 and make clear that presentment must be made to the particular secondary party to be charged. However, notice of dishonor might be construed to be a pre-

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240 U.C.C. § 3-503(1)(e).
241 See 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, REPORT ON SECTION 3-504, 120. Section 3-504(1) now defines "presentment" as "a demand for acceptance or payment made upon the maker, acceptor, drawee, or other payor by or on behalf of a holder." (Emphasis added.)
sentiment since a presentment is defined as a demand for payment and "notice of dishonor is a demand." This problem could easily be alleviated by making notice of dishonor ineffective after a certain period. Alternatively, timely presentment could be required of each person seeking payment. Thus, even though holder Z might have given notice of dishonor to indorser B and drawer A, if B paid the instrument he would be required to make an additional timely presentment to A. Perhaps the drafters had this alternative approach in mind when they amended the definition of "presentment" in 1958. Such a requirement could be enforced under the present U.C.C., since section 3-603(2) gives all payors the rights of their payee and any payee who was a holder or a transferee of a holder had the right to make a presentment.

Section 3-605

Section 3-605 provides:

(1) The holder of an instrument may even without consideration discharge any party

(a) in any manner apparent on the face of the instrument or the indorsement, as by intentionally cancelling the instrument or the party's signature by destruction or mutilation, or by striking out the party's signature; or

(b) by renouncing his rights by a writing signed and delivered or by surrender of the instrument to the party to be discharged.

(2) Neither cancellation nor renunciation without surrender of the instrument affects the title thereto.

The right to discharge a party is an owner's right, as is the right to give away or sell part of one's property. In effect, this is what the owner of a negotiable instrument does when he cancels or renounces his rights against a party liable or potentially liable on the instrument. Section 3-605 goes one step further and gives these rights to the holder. This approach is consistent with treating the holder as the presumptive owner, and it allows people dealing with negotiable instruments to order their affairs. Any payor who has rights against another party should have this right of discharge, which is granted by section 3-603(2).

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242 Not all notices of dishonor could be presentments. U.C.C. § 3-504(1) states that a presentment "is a demand . . . made . . . by or on behalf of a holder." Notice of dishonor need not be given by or on behalf of a holder. U.C.C. § 3-508(1) states that "notice of dishonor may be given to any person who may be liable on the instrument by or on behalf of the holder or any party who has himself received notice, or any other party who can be compelled to pay the instrument." (Emphasis added.) Thus, A issues a check to B, who indorses it to C, who indorses it to D, and D presents it to the drawee, who dishonors. If D only notifies C and B, and B notifies A before B pays the instrument, A has received notice of a dishonor but he probably has not received presentment since B was not a holder and was not acting on behalf of the holder.

243 U.C.C. § 3-504(1).
244 U.C.C. § 3-122(3).
245 U.C.C. § 3-201(5).

246 An interesting problem to consider is the possible conflict between U.C.C. §§ 3-606(1)(a) and 3-415(3). The former section requires the right of recourse to be known by the holder-discharger. For example, suppose A issued a note to B in return for certain goods that B did not completely deliver, and B negotiates the note to C after maturity. If X was an accommodation maker but C did not know of the accommodation and discharged A, § 3-606(1)(a) would allow C rights against X. See U.C.C. § 3-606, comment 3. However, §
Sections 4-203 and 4-204

Section 4-203 provides:
Subject to the provisions of Article 3 concerning conversion of instruments (Section 3-419) and the provisions of both Article 3 and this Article concerning restrictive indorsements only a collecting bank’s transferor can give instructions which affect the bank or constitute notice to it and a collecting bank is not liable to prior parties for any action taken pursuant to such instructions or in accordance with any agreement with its transferor.

Section 4-204 provides:
(1) A collecting bank must send items by reasonably prompt method taking into consideration any relevant instructions, the nature of the item, the number of such items on hand, and the cost of collection involved and the method generally used by it or others to present such items.
(2) A collecting bank may send
(a) any item direct to the payor bank;
(b) any item to any non-bank payor if authorized by its transferor; and
(c) any item other than documentary drafts to any non-bank payor, if authorized by Federal Reserve regulation or operating letter, clearing house rule or the like.
(3) Presentment may be made by a presenting bank at a place where the payor bank has requested that presentment be made.

Subject to the sections on restrictive indorsements, these sections permit a customer to give binding instructions to the depositary bank. Any payor who starts the instrument in the collection process would be a transferor to a “collecting bank.” Section 3-603(2) is unnecessary here.

Conclusion

Section 3-603(2) is aimed primarily at helping a stranger-payor or an accommodation party-payor. If the U.C.C. did not contain a section comparable to this one, the stranger-payor might be in the anomalous position of being unable either to negotiate the instrument further unless it was in blank, or present it for payment to any payor.

Similarly, without a section comparable to section 3-603(2), the accommo-

3-415(3) allows the accommodation maker to introduce oral proof of the accommodation character against a nonholder in due course. Such proof would enable the accommodation maker to receive “the benefit of discharges dependent on his [accommodation] character as such.” Thus, in the above hypothetical, C would have no rights against X. Since the accommodation maker still has a right to indemnity, § 3-606(1)(a), unmodified by § 3-415(3), might be the fairer approach.

247 U.C.C. §§ 3-206(2), 4-205(2).
248 U.C.C. § 4-104(1)(e).
249 U.C.C. § 4-105(a).
250 U.C.C. § 4-105(d).

251 Since there would not be a U.C.C. § 3-603(2), the stranger-payor would not receive the benefit of U.C.C. § 3-201(3) and thus could not become a holder. See U.C.C. § 3-505. As a practical matter, the stranger-payor would probably have trouble even transferring the instrument since most people would not take an instrument of which they could not become a holder.

252 See U.C.C. §§ 3-413(1), (2), 414(1). The stranger-payor is probably not a surety and thus would not receive his presentor’s rights by means of subrogation.
Section 3-603(2) enables an accommodation party to avoid formalistic decisions like *Quimby v. Varnum* in which the court reasoned that since an accommodation indorser had no rights on the instrument when he first indorsed, he had no rights when he paid since N.I.L. section 121 remitted an indorser-payor to his former position.

It is true that section 3-603(2) also aids certain indorser-payors. For example, suppose that A issues a note to B as a gift, and B negotiates the note to C. If A dishonors when C presents the note at maturity, B would have to pay. As a donee, B would have no rights against his donor. However, under section 3-603(2), B would be given C's rights against A. Such a result could be justified if B relied upon the note, for the promise to pay the note would no longer be a “naked promise,” but would be supported by consideration. Perhaps the sale of the note shows such reliance. However, it could be argued that an *ad hoc* approach would be more appropriate. If B received the same amount from C that he later paid C, it could be argued that B did not suffer any damage. Even if B received less from C than he later paid him, it is not clear that B was injured. Arguably, the difference between the amount B paid and the amount that he had originally received is the cost of B’s having the use of C’s money during the period that C held the note. At most, B was injured only to the extent of the difference between what B received and what he later had to pay. In any event, it is clear that section 3-603(2) causes undesirable results in many situations involving indorser-payors.

A review of the two major problems that were considered in this article is appropriate. The first question is whether a payor has the rights and duties of a transferee or holder, even without the benefit of section 3-603(2). The second question is whether a payor should have such rights and duties in any case. As was observed earlier, absent section 3-603(2), no payor has all the rights of a transferee or holder. It is clear that the lack of certain of these rights may cause injustice to particular payors in some situations, but it is equally clear that it would be inappropriate to give all payors, or even one particular payor, all the rights of a holder or transferee. Thus, section 3-603(2), which gives all payors these rights, is too broad and must be redrafted.

253 U.C.C. § 3-415(5) gives the accommodation indorser rights only against the party accommodated.

254 190 Mass. 211, 76 N.E. 671 (1906). *But see* Lill v. Gleason, 92 Kan. 754, 142 Pac. 287 (1914), for a more reasonable approach to the same problem.

255 Bargained for reliance is good consideration. Unbargained for reliance should be good consideration. *Restatement, Contracts* § 90 (1932).