

THE LAW OF NEGOTIABLE INSTRUMENTS AND BANK COLLECTIONS UNDERGOES MAJOR CHANGES: INDIANA REPLACES ARTICLE 3 AND UPDATES ARTICLE 4 OF THE UNIFORM COMMERCIAL CODE

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INTRODUCTION

Once again, the Legislature has moved to keep Indiana commercial law in step with modern business and banking practice, this time by following the recommendations of the sponsors of the Uniform Commercial Code and replacing Uniform Commercial Code Article 3—Commercial Paper with a completely Revised Article 3—Negotiable Instruments, and by making major changes in Article 4—Bank Deposits and Collections, plus appropriate conforming changes in the definitions sections of Article 1 and in other parts of the Code, all of which becomes effective on July 1, 1994.¹ The Revised Article 3, designated Chapter 3.1 of Indiana's U.C.C., completely replaces its predecessor Chapter 3,² which was enacted in 1963.³ Chapter 3 of Indiana's U.C.C. was itself a revision of the Uniform Negotiable Instruments Law which had been the law of Indiana since 1913.⁴ The changes in Article 4 (Indiana's Chapter 4

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1. See Pub. L. No. 222-1993, § 58, 1993 Ind. Legis. Serv. 2416 (West) ("IC 26-1-3 is repealed [effective July 1, 1994]"), and the headings to the various sections of Pub. L. No. 222-1993, § 58, 1993 Ind. Legis. Serv. 2416 (West).

2. See Pub. L. No. 222-1993 § 5, 1993 Ind. Legis. Serv. 2364 (West) ("IC 26-1-3.1 is added to the Indiana Code as a *new* chapter to read as follows [effective July 1, 1994]").

3. 1963 Ind. Acts ch. 317. The U.C.C. appears at IND. CODE §§ 26-1-1-101 to -10-106 (1988 & Supp. 1992). Hereafter, reference to pre-1992 sections of the U.C.C. will be to generic section numbers rather than to the Indiana Code numbers, e.g., § 3-101 rather than § 26-1-3-101, unless the Indiana version differs from the Official 1987 draft. Reference to sections of Revised Article 3, to changes in Article 4, and to any corresponding changes in other articles, will contain the letter "R," e.g., § 3R-101 and § 4R-101. Both articles may be referred to herein simply as the "Revisions."

4. See HARRY R. PRATTER & R. BRUCE TOWNSEND, INDIANA UNIFORM COMMERCIAL CODE WITH COMMENTS 98 (1963). The Uniform Negotiable Instruments Law (N.I.L.) had been promulgated by the National Conference of Commissioners on Uniform State Laws in 1896 and was based on the English Bill of Exchange Act of 1882. See U.C.C. Rev. Art. 3 prefatory note, 2 U.L.A. 7 (1991) [hereinafter "Art. 3R prefatory note"]; Robert L. Jordan & William D. Warren, *Introduction to Symposium: Revised U.C.C. Articles 3 & 4 and New Article 4A*, 42 ALA. L. REV. 373, 385 (1991). One author has characterized the N.I.L. as "a rather slavish copy" of the English Act and that Act as "an unimaginative codification of preexisting common law," which developed over the preceding two centuries. Robert G. Ballen et al., *Commercial Paper, Bank Deposits and Collections, and Other Payment Systems*, 44 BUS. LAW. 1515, 1539 (1989) (The portion of this Survey dealing with the revisions of Articles 3 and 4 was written by Edward L. Rubin. *Id.* at 1515.) [hereinafter 1989 U.C.C.]

of the U.C.C.), are also quite extensive. The changes are intertwined with the changes to Article 3 and affect the bank collection process, which deals mainly with the processing and payment of checks. With this enactment, Indiana has joined at least thirty other states in adopting the new provisions.⁵

These Revisions by the National Conference of Commissioners on Uniform State Laws and the American Law Institute, the original sponsors of the U.C.C., were a companion to the creation of new Article 4A on electronic funds transfers,⁶ which was added to Indiana's U.C.C. in 1991.⁷ As noted by the drafters, the original Articles 3 and 4 were written for a relatively slow, paper-based payment system that did not anticipate new electronic technologies or the explosion in check processing volume.⁸ Moreover, as with any statute of the Code's complexity, problems of application and interpretation of Articles 3 and 4 surfaced over the years and called for clarification or revision.

A comprehensive analysis of all of the changes to Articles 3 and 4 would require a work far longer and more detailed than this survey article.⁹ Rather,

Survey].

5. See Fred H. Miller, *Et Sic Ulterius*, UCC BULLETIN 2 (Sept. 1993); A.B.A. Sec. on Bus. Law, UCC Committee Update, *UCC Scorecard: 50 State Survey of Adoptions of Revised Official Text of the UCC* 14 (June, 1993). Prof. Miller reports adoption in Alaska, Arizona, Arkansas, California, Connecticut, Florida, Hawaii, Idaho, Illinois, Indiana, Kansas, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Dakota, Oklahoma, Pennsylvania, Utah, Virginia, Washington, West Virginia, and Wyoming.

6. Art. 3R prefatory note, *supra* note 4.

7. IND. CODE § 26-1-4.1 (Supp. 1992). See Harold Greenberg, *Indiana Adds Articles 2A and 4A of Uniform Commercial Code*, 25 IND. L. REV. 1029 (1992).

8. Art. 3R prefatory note, *supra* note 4. Professors Jordan and Warren have observed: Some of the official comments [to the original Code] suggest that the drafters envisioned a bookkeeper with a green eyeshade and black sleevelets carefully examining each check before marking it "paid" and placing it in the customer's file. This antiquated notion is entirely impractical today. Approximately 56 billion checks were drawn in the United States in 1990.

Jordan & Warren, *supra* note 4, at 392 (footnotes omitted).

9. See, e.g., JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE (3d ed. 1993 Pocket Part) [hereinafter WHITE & SUMMERS]; Henry J. Bailey, *New 1990 Uniform Commercial Code: Article 3, Negotiable Instruments, and Article 4, Bank Deposits and Collections*, 29 WILLAMETTE L. REV. 409 (1993); Arthur G. Murphey, Jr., *Revised Article 3 and Amended Article 4 of the Uniform Commercial Code: Comments on the Changes They Will Make*, 46 ARK. L. REV. 501 (1993). Part One of the White & Summers 1993 pocket part to their 1988 text contains 127 pages of discussion of the Revisions. Prof. Bailey's article is a 156-page, section by section analysis of the Revisions, in which the author recommends against their further enactment until his recommended changes are made. See *id.* at 410. Prof. Murphey's article covers 103 pages. The Revisions have also generated numerous articles and symposia analyzing the drafting process and individual provisions. See, e.g., Symposium, *Is the UCC Dead, or Alive and Well?*, 26 LOY. L.A. L. REV. 535 (1993) (including more than Articles 3 and 4); Symposium, *Revised U.C.C. Articles 3 & 4 and New Article 4A*, 42 ALA. L. REV. 351 (1991); Mark E. Budnitz, *The Consequences of Bulk in Our Banking Diet: Bulk Filing of Checks and the Bank's Duty of Ordinary Care Under the 1990 Revision to the Uniform Commercial Code When It Honors Forged Checks*, 63 TEMP. L. REV. 729 (1990); Patricia L. Heatherman, Note, *Good Faith in Revised Article 3 of the Uniform Commercial*

this article will attempt to highlight the more significant changes brought about by these enactments, with a particular emphasis on Indiana law. This article is written on the assumption that the reader has at least a basic understanding of the law applicable to negotiable instruments and the bank collection process found in Articles 3 and 4.

I. PRELIMINARY OBSERVATIONS

A. *The Official Comments*

As with the other articles and earlier versions of the Code, the drafters have performed an invaluable service by including Official Comments to each of the sections in the Revisions. In many instances, these comments are extensive and contain numerous hypothetical examples of precisely how the drafters intended the particular sections to work.¹⁰ Although the Official Comments are not part of the Code text and were not before the Legislature when the Revisions were enacted, they are the best available scholarly explanation of the meaning and operation of the Revisions and are the nearest thing to specific drafting history short of actual legislative reports.¹¹

B. *Application of the Old and New Provisions*

Lawyers, law students, judges and scholars have all long struggled with Articles 3 and 4 and with the concepts they embody. With the enactment of the Revisions, the situation becomes doubly complex because both the old and new versions may be applicable to the same transaction or instrument. For example, the substantive characteristics of promissory notes created prior to the effective date of the Revisions presumably will still be governed by the original Article

Code: Any Change? Should There Be? 29 WILLAMETTE L. REV. 567 (1993).

For general treatment of the revisions and the revision process, see, e.g., Robert G. Ballen et al., *Survey: Commercial Paper, Bank Deposits and Collections, and Other Payment Systems*, 46 BUS. LAW. 1521, 1539-56 (1991) [hereinafter "1991 U.C.C. Survey"]; 1989 U.C.C. Survey, *supra* note 4; Fred H. Miller, *Report on the New Payments Code*, 41 BUS. LAW. 1007 (1986); Edward L. Rubin, *Policies and Issues in the Proposed Revision of Articles 3 and 4 of the UCC*, 43 BUS. LAW. 621 (1988); Symposium, *Revised U.C.C. Articles 3 & 4 and New Article 4A*, 42 ALA. L. REV. 351 (1991).

10. See, e.g., § 3R-302, cmts. 4, 6 (6 illustrative cases); § 3R-312, cmt. 4 (6 illustrative cases); § 3R-404, cmt. 2 (5 illustrative cases); § 3R-405, cmt. 3 (7 illustrative cases).

11. This is clearly in keeping with the original intention of the first chief reporter of the U.C.C., Karl Llewellyn, who, in the earliest stages of Code drafting, was unwilling to await the publication of later scholarly explanations of, treatises about, the statute. Instead, he insisted on the concurrent drafting of comments to clarify and explain the provisions of the new law. See Letter from Karl Llewellyn to Dr. William Draper Lewis, Director of the American Law Institute (Feb. 27, 1942)(in the Archives of the A.L.I., Phila., PA). See also JOHN HONNOLD, *CASES AND MATERIALS ON THE LAW OF SALES AND SALES FINANCING* 12-13 (4th ed. 1976); Harold Greenberg, *Specific Performance under Section 2-716 of the Uniform Commercial Code: "A More Liberal Attitude" in the "Grand Style,"* 17 NEW ENG. L. REV. 321, 327 (1982).

3. Notes created after that date will be governed by the Revision. The transfer of pre-Revision notes, however, would seem to be governed by the law in effect on the date of any transfer, which could take place either before, or after, the effective date or even both if there is more than one transfer. Because promissory notes, particularly those given in real estate transactions, often remain outstanding for many years, it will be necessary to be familiar with both versions of Article 3.

Checks, on the other hand, are demand instruments,¹² and usually do not remain outstanding for long periods of time. Nevertheless, both versions of Articles 3 and 4 may be involved, for example, if there is a series of forgeries by one wrongdoer that straddles the effective date, or if a check is issued and certified prior to the effective date but is presented and dishonored thereafter. Post-dated checks or non-check drafts, *i.e.*, drafts on which the drawee is not a bank, may be issued prior to the effective date of the Revisions but payable after that date, thereby also involving the applicability of both versions of Articles 3 and 4.

C. Format

One change that relates more to style than to substance is the shift away from the "laundry list" approach of Article 3 to a more narrative, paragraphed style in the Revision. The explanation for this change is "to bring it more into the drafting style of the other articles of the UCC."¹³ This author questions whether the relatively easier use of a laundry list or checklist in applying a highly complex and technical statute should have been sacrificed for consistency of style.

The drafters have tried to retain many of the old and familiar section numbers. For example, the holder in due course of § 3-302 is dealt with in § 3R-302. However, the subdivision, deletion, and substantial revision of some sections has precluded perfect parallel numbering.

II. SIGNIFICANT CHANGES

The Revisions have made changes of particular significance in four areas: The personal liability of an agent who signs on behalf of a principal; the liability and discharge of accommodation parties or sureties; the replacement of a strict, contributory negligence scheme with comparative negligence; and the facilitation of "check truncation" in the collection process.¹⁴ The rules in several other

12. See U.C.C. §§ 3-104(2)(b), 3R-104(f).

13. N.C.C.U.S.L., Draft Amendments to U.C.C. Article 3 — Negotiable Instruments, Prefatory Note, p. 1 (July, 1989).

14. WHITE & SUMMERS believe that the first two of these are the most significant changes in Article 3. See WHITE & SUMMERS, *supra* note 9, § 13-1 (Supp. 1993). Prof. Bailey believes that the adoption of comparative negligence is indeed significant but also ill-advised. See Bailey, *supra*

areas have been clarified by amendment or redrafting. These changes will be discussed more specifically following the discussion of matters of general application.

III. GENERAL DEFINITIONS

The definition of “bank” within Article 4 coverage has been expanded to include expressly savings and loans, savings banks, credit unions, trust companies, and any other person in the business of banking.¹⁵ “‘Account’ is defined as any deposit or credit account with a bank, including a demand, time, savings, passbook, share draft, or like account, other than an account evidenced by a certificate of deposit.”¹⁶ These definitions put to rest any doubts as to whether the rules of Article 4 apply to credit unions or savings and loan associations.

IV. STATUTE OF LIMITATIONS

The Revisions have added a specific statute of limitations, which did not previously appear in Article 3 and appeared only in a limited respect in Article 4¹⁷. An action to enforce a note payable at a definite time must be brought within six years after the stated accelerated due date.¹⁸ An action to enforce a demand note must be brought within six years after the demand. If no demand is made upon the maker, “an action to enforce the note is barred if neither principal nor interest on the note has been paid for a continuous period of 10 years.”¹⁹ If the instrument is a certified check, teller’s check, cashier’s check, or traveler’s check, the action must be brought within three years after demand for payment.²⁰ An action for conversion, breach of presentment or transfer warranty, or to enforce an obligation, duty or right under Articles 3R or 4 must be brought within three years after the cause of action accrues.²¹ These sections do not deal with all rules relating to statutes of limitations, such as tolling the statute. Such matters are left to other law of the jurisdiction.²²

note 9, at 426-30.

15. § 4R-105(1) and cmt. 2.

16. § 4R-104(a)(1).

17. See § 4-406(4).

18. § 3R-118(a).

19. § 3R-118(b).

20. § 3R-118(d).

21. §§ 3R-118(g), 4R-111.

22. § 3R-118, cmt. 1.

V. NEGOTIABILITY AND HOLDERS IN DUE COURSE

A. *Form and Content*

Despite criticism of the concepts of negotiability and holder in due course²³ and the elimination of holders in due course in consumer transactions,²⁴ these two concepts remain a basic part of Revised Article 3, with some changes in the rules relating to the characteristics required for negotiability or for holding in due course.

Under Revised Article 3, the statement on consumer credit notes mandated by F.T.C. Regulation that the holder is subject to claims and defenses of the maker²⁵ no longer renders the note conditional, non-negotiable, and therefore outside the scope of Article 3.²⁶ Such notes remain within the scope and rules of the U.C.C., but the holder cannot be a holder in due course.²⁷

The Revision continues to require for negotiability the "words of negotiability," *i.e.*, that the instrument be "payable to bearer or to order at the time it is issued. . . ."²⁸ However, if the paper meets all of the requirements for being a check except that it lacks these words of negotiability, it nevertheless is negotiable and can be negotiated to a holder in due course.²⁹ Other drafts or promissory notes that lack the words of negotiability are not negotiable and are excluded from Revised Article 3 coverage unless the parties expressly agree to such coverage or the court applies the rules of the Code as a matter of common law development.³⁰ This is a change from Article 3, which provides that paper which is technically non-negotiable solely because it lacks the order or bearer words of negotiability is still governed by Article 3, but that there can be no holder in due course thereof.³¹

Under the Revision, an instrument that purports to be payable to the order of "a named person or bearer" is payable to bearer, not to order, whether or not

23. *See, e.g.*, GRANT GILMORE, *THE DEATH OF CONTRACT* 108-09 n.18 (1974); Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441 (1979); Albert J. Rosenthal, *Negotiability—Who Needs It?*, 71 COLUM. L. REV. 375 (1971).

24. *See* F.T.C. Reg., 16 C.F.R. § 433 (1993) (consumer credit contracts, including notes, must state that they are subject to the consumer's claims and defenses); Uniform Consumer Credit Code § 2.403 (1968 Version), IND. CODE § 24-4.5-2-403 (1988 & Supp. 1992) (negotiable instruments other than checks prohibited in consumer sales or leases other than for agricultural purposes; holder taking such instrument with notice of violation of this section not in good faith); WHITE & SUMMERS, *supra* note 9, § 14-8.

25. 16 C.F.R. § 433 (1993).

26. *See* §§ 3-104(1)(b), 3R-106, cmt. 3; WHITE & SUMMERS, *supra* note 9, § 14-8.

27. § 3R-106(d).

28. *Compare* § 3R-104(a)(1) with § 3-104(1)(d).

29. *See* § 3R-104(c), and cmt. 2.

30. *Id.*; *see* §§ 1-102(2)(b), 3R-104, cmt. 2.

31. § 3-805.

the “bearer” language is handwritten or is printed on a form check.³² This is a change in the law under § 3-110(3) which provides that an instrument payable to order of “a named person or bearer” is order paper unless the bearer language is hand- or type-written.³³

The Revision permits variable interest rate notes by permitting “reference to information not contained in the instrument,” but if the rate cannot be ascertained, it is payable at the then current judgment rate.³⁴ In 1990, the Indiana Legislature amended the then existing provision on interest rates stated in negotiable instruments to permit variable interest rates,³⁵ thereby avoiding a problem that had split other jurisdictions on whether variable interest rate promissory notes were negotiable.³⁶ The 1990 enactment, however, is more specific than the Revision in that it lists four points to which reference can be made; the Revision does not list any.³⁷ As the more recent enactment, the Revision supersedes the 1990 Indiana version of this Code section.

A note or draft is no longer made conditional and, therefore, non-negotiable because payment is limited to a particular fund or source.³⁸ The drafters explain that if potential buyers of instruments do not want to purchase such instruments, they need not do so, but such instrument should still be governed by Code rules. Market forces will control the popularity and price of such instruments.³⁹

32. See § 3R-109 and cmt. 2.

33. In the author's experience, many rebate checks from manufacturers of goods who engage in various promotions have the name of a payee typed in, but the words “or bearer” are pre-printed in the same print as other pre-printed language on the check, such as “Pay to the order of.” Under Article 3, such checks are order paper and negotiable only by the named payee. Under the Revision, such checks are bearer paper and can be negotiated by anyone. Thus, the forgery of the named person's signature would not break the chain of title because that signature is not necessary to the chain of title to bearer paper. A clever thief could take such checks from the mail and successfully negotiate them into the hands of holders in due course, thereby reaping a substantial, although illegal, profit at the expense of the drawer.

34. § 3R-112(b).

35. IND. CODE § 26-1-3-106 (Supp. 1992).

36. See Harold Greenberg, *Recent Developments in Contract and Commercial Law*, 24 IND. L. REV. 573, 575-76 (1991).

37. Compare § 3R-112(b) (“reference to information not contained in the instrument”) with IND. CODE § 26-1-3-106(1)(a)-(d) (Supp. 1992) (“reference in the instrument to: (a) a published rate or federal statute, regulation, or rule of court; or (b) a generally accepted financial index; or (c) a compendium of rates; or (d) an announced rate of a named financial institution”).

38. § 3R-106(b)(ii). Compare § 3-105(2)(b) which states that “[a] promise or order is not unconditional [and is therefore non-negotiable] if the instrument (b) states that it is to be paid only out of a particular fund or source”

39. § 3R-106, cmt. 1.

B. "Good Faith" and Notice

The Revision redefines "good faith" for the purposes of Articles 3 and 4 as "honesty in fact and the observance of reasonable commercial standards of fair dealing,"⁴⁰ thereby adding to the subjective "honesty in fact" test for good faith found in § 1-201(19) an objective standard of fair dealing in all Article 3 and 4 transactions. Prior to the Revisions, an objective standard applied only to the determination of whether a taker took with notice of problems so as to deprive her of holder in due course status.⁴¹ An addition in the Revision is a definition of "ordinary care," which "in the case of a person engaged in business means observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged."⁴² The drafters note that these definitions apply to both Articles 3R and 4 but are directed to different aspects of the same transaction. "Good faith" goes to the basic fairness of the transaction; "ordinary care" goes to the care with which the transaction is conducted.⁴³

Section 3R-307 adds new rules that clarify when a taker has notice of breach of fiduciary duty, thus depriving her of holder in due course status, and that impose stricter standards on the taker who deals with a fiduciary.⁴⁴ The section protects the taker by requiring "knowledge" of the fiduciary status of the transferor of the instrument before the specific rules for "notice" of breach of fiduciary duty come into play.⁴⁵ With such knowledge, the taker has the requisite notice of breach of duty if an instrument drawn by, or payable to, either the represented person or to the fiduciary as fiduciary is, with the knowledge of the taker, being used for the personal purposes of the fiduciary or the proceeds are going into an account other than that of the represented person or other than

40. § 3R-103(a)(4); see § 4R-104(c).

41. See § 3R-302(a)(2); Robert G. Ballen & Paul Homrighausen, *Revised Articles 3 and 4: Selected Topics*, 24 U.C.C. L.J. 3, 10-11 (1991). In *E. Bierhaus & Sons, Inc. v. Bowling*, 486 N.E.2d 598 (Ind. Ct. App. 1985), the court discusses and distinguishes between the subjective test of good faith and the objective test of lack of notice of problems with the transaction.

During the course of the enactment process, the Indiana Bankers Association proposed that the objective good faith standard of "observance of reasonable commercial standards of fair dealing" apply only to the issue of whether the taker becomes a holder in due course but not to other transactions under Articles 3 and 4 which would continue to be governed by the subjective, "honesty in fact" test. Why the Association sought this result is unstated. Its position was not adopted by the Legislature.

42. § 3R-103(a)(7).

43. See § 3R-103, cmts. 4, 5.

44. See Art. 3R prefatory note; § 3R-307, cmt 1. As noted in the official comment, the usual situation is one of embezzlement by the fiduciary for personal use. *Id.*, cmt. 2. For a comprehensive discussion of how the Revision treats fiduciary fraud, see Marion W. Benfield, Jr. & Peter A. Alces, *Bank Liability for Fiduciary Fraud*, 42 ALA. L. REV. 475 (1991).

45. See § 3R-307(b)(ii). "A person 'knows' or has 'knowledge' of a fact when he has actual knowledge of it." § 1-201(25).

the fiduciary's fiduciary account.⁴⁶ However, if the person represented or the fiduciary as fiduciary issues an instrument payable to the fiduciary personally, the taker is not charged with notice of impropriety unless she has knowledge of the breach of fiduciary duty.⁴⁷

In order to be a holder in due course, the taker must take without notice that it is overdue.⁴⁸ In an effort to clarify the rules regarding such notice, all demand instruments are overdue on the day after demand for payment is made.⁴⁹ With respect to demand instruments of which payment has not been demanded, a check is now overdue 90 days after its date, as compared to 30 days after date under old Article 3.⁵⁰ Other demand instruments are overdue when the instrument has been outstanding for an unreasonably long period of time.⁵¹

VI. CASHIER'S CHECKS, TELLER'S CHECKS, CERTIFIED CHECKS, AND TRAVELER'S CHECKS

Cashier's checks, teller's checks, certified checks, and traveler's checks, although negotiable instruments, are treated in the real world as the equivalent of cash. Article 3 contains no rules or definitions specifically applicable to these instruments other than to state that certification of a check by the drawee bank is acceptance of that check,⁵² that the accepting bank engages that it will pay the instrument,⁵³ and that the obligation underlying the issuance of an instrument is discharged "if a bank is drawer, maker or acceptor . . . and there is no recourse on the instrument against the underlying obligor. . . ."⁵⁴ Problems with these instruments have included whether payment can be stopped and, with respect to traveler's checks, who is liable when the countersignature is forged. The Revision defines each of these instruments⁵⁵ and states some specifically

46. See § 3R-307(b)(2),(4).

47. See § 3R-307(b)(3) and official comment 4; Ballen, *1991 U.C.C. Survey*, *supra* note 9, at 1543-44.

48. §§ 3-302(1)(c), 3R-302(a)(2)(iii).

49. § 3R-304(a)(1).

50. Compare § 3R-304(a)(2) with § 3-304(3)(c).

51. § 3R-304(a)(3).

52. § 3-411(1).

53. § 3-413(1): "The maker or acceptor engages that he will pay the instrument according to its tenor at the time of his engagement"

54. § 3-802(1)(a).

55. § 3R-104:

(g) "Cashier's check" means a draft with respect to which the drawer and drawee are the same bank or branches of the same bank.

(h) "Teller's check" means a draft drawn by a bank (i) on another bank or (ii) payable at or through a bank.

(i) "Traveler's check" means an instrument that (i) is payable on demand, (ii) is drawn on or payable at or through a bank, (iii) is designated by the term "traveler's check" or by a substantially similar term, and (iv) requires, as a condition to payment, a countersignature by a person whose specimen signature appears on the instrument.

applicable rules. If the obligated bank, *i.e.*, the acceptor of a certified check or issuer of a cashier's or teller's check, refuses to pay or stops payment, the enforcer of the check may recover expenses, loss of interest, and consequential damages. Expenses and consequential damages are not recoverable if the bank "asserts a claim or defense of the bank that it has reasonable grounds to believe is available against" the enforcer, the bank has reasonable doubt about the enforcer's right to enforce the check, or payment is enjoined.⁵⁶ The drafters designed this section expressly to discourage the occasional practice of banks to refuse or stop payment of these instruments as an accommodation to their customers.⁵⁷ Short of being enjoined by a court of record, most banks will now pay these instruments rather than run the risk of substantial damages.

There is also a detailed procedure to be followed in the event that a certified, teller's, or cashier's check is lost, destroyed, or stolen from the drawer or remitter. The purpose of this section is to enable the drawer or remitter to obtain a refund of the amount involved without the necessity of posting an expensive bond but also to continue protecting the bank.⁵⁸

If any of these three types of checks is taken for an obligation, it is as if the obligor paid cash to the obligee and the obligation is discharged to that extent. However, if the obligor indorsed the instrument, indorser's liability continues.⁵⁹

With respect to traveler's checks, the requirement of a countersignature by the person whose signature already appears on the traveler's check does not make the instrument conditional and non-negotiable.⁶⁰ Moreover, the countersignature is not an indorsement but is for the purpose of identifying the owner of the instrument. Thus, if a forgery of the countersignature is relatively skillful and the taker of the traveler's check acts in good faith, the taker may be a holder in due course and cut off the defense of the issuer that the countersignature was forged. Because a countersignature is not an indorsement, the forgery does not break the chain of title. On the other hand, if the forgery is poor or if the purported signer is unable to present satisfactory identification when requested to do so, there may be notice that would deprive the taker of holder in due course status.⁶¹

§ 3R-409(d): "'Certified check' means a check accepted by the bank on which it is drawn."

56. § 3R-411(c) and the cmt. thereto.

57. *Id.*, cmt. 1.

58. See § 3R-312, and the cmt. thereto. The comment contains several hypothetical examples of how this section is intended to function.

59. See § 3R-310(a).

60. § 3R-106(c).

61. See *id.*, cmt. 2.

VII. AGENT AND CORPORATE LIABILITY

The Revision clarifies and changes some of the rules regarding the liability of principals and agents whose signatures do, or do not, appear on negotiable instruments.⁶² An important change is the provision in § 3R-402(a), which now makes an undisclosed principal liable on an instrument to the same extent the undisclosed principal would be bound if the signature were on simple contract despite the fact that the principal's signature does not appear on it and provided the agent had authority to represent the principal. The undisclosed principal is liable even though the agent signed only her own name, did not indicate agency status, and did not name the principal.⁶³ Although the undisclosed principal may be liable on the underlying obligation as a matter of agency law, the corresponding provision in Article 3⁶⁴ has been interpreted to impose liability on the instrument solely upon the agent but not on the principal unless the principal was actually named or otherwise indicated.⁶⁵ The justification for that result apparently was that the principal's signature did not appear on the instrument, and no one is ordinarily liable on an instrument he did not sign. Moreover, if the dispute was with the payee who knew that the agent was acting as agent, the agent indicated her representative capacity on the instrument, but the principal's name did not appear on the instrument, it was possible for neither the agent nor the principal to be liable on the instrument. The Revision is more in keeping with the law of agency with respect to the liability of an undisclosed principal.⁶⁶

Ordinarily, if the signing agent does not unambiguously sign in a representative capacity or if the principal is not identified in the instrument, the agent will be liable on the instrument to a holder in due course who took without notice that the agent was not intended to be liable.⁶⁷ However, the Revision makes clear that an authorized agent who, without indicating a representative capacity, signs a check that bears the principal's name is not liable on the check, even to a holder in due course.⁶⁸ As noted in the official comment, virtually all checks in current use identify the account owner, and "nobody is deceived into thinking that the person signing the check is meant to be liable."⁶⁹

This last provision would have simplified the decision process in *Highfield v. Lang*,⁷⁰ in which the corporate principal's name was printed on the checks

62. Prof. Bailey characterizes § 3-403 as "one of the more 'difficult' provisions" of old Article 3. Bailey, *supra* note 9, at 480.

63. See § 3R-402(a) and cmt. 1 thereto.

64. § 3-403.

65. See WHITE & SUMMERS, *supra* note 9, § 13-3.

66. § 3R-401, cmt. 1.

67. § 3R-402(b)(2).

68. § 3R-402(c).

69. *Id.*, cmt. 3.

70. 394 N.E.2d 204 (Ind. App. 1979).

but the signing agent did not indicate her representative capacity. After the checks were dishonored, the payee attempted to impose personal liability on the agent. The court observed that “[a]lthough the evidence was conflicting,” there was evidence from which the trial court could reasonably conclude that the payee knew that the signing agent was a corporate vice-president, which absolved her of personal liability.⁷¹ Had the check found its way into the hands of a holder in due course, the then applicable Code provision would likely have resulted in agent liability.

VIII. FULL PAYMENT CHECKS AND ACCORD AND SATISFACTION

Section 3R-311 and a corresponding amendment to § 1-207 resolve a split in the jurisdictions and in scholarly opinion regarding both the use of “full payment” checks as an accord and satisfaction and the creditor’s reservation of rights prior to indorsing such checks. At common law, when a debt was disputed, the debtor could offer an accord and satisfaction of the debt by sending a check to the creditor for a lesser amount than claimed and bearing language that the check was in full payment of the outstanding debt. By cashing the check, the creditor agreed to an accord and satisfaction. In the judgment of some courts and scholars, the enactment of § 1-207 enabled creditors to note a reservation of rights on such a check prior to indorsement, thereby preserving the balance of the claim. The majority of courts, however, determined that § 1-207 did not change the common law rule.⁷²

Accompanying Revised Article 3 is an amendment to the § 1-207 provision on reservation of rights stating expressly that the section “does not apply to an accord and satisfaction.”⁷³ Further, § 3R-311 states specific rules that apply when a debtor⁷⁴ on an unliquidated or disputed claim, in good faith, tenders an instrument in full payment, and the claimant obtains payment of the instrument. If the instrument or accompanying memo states conspicuously that it is in full satisfaction of the disputed claim, the claim is discharged. However, it will not be discharged if the payee is an organization that had previously notified the debtor that disputes, including full satisfaction checks, were to be sent to a specific person or place and the instrument was not received by that person or

71. *Id.* at 206. See generally Gerald L. Bepko, *Contracts, Commercial Law, and Consumer Law*, 14 IND. L. REV. 223, 236-38 (1981).

72. See, e.g., WHITE & SUMMERS, *supra* note 9, § 13-24; Nadine DeLuca Elder, Note: *Displacing Accord and Satisfaction in Massachusetts with U.C.C. Section 1-207*, 25 SUFFOLK U. L. REV. 637 (1991); Patricia B. Fry, *You Can't Have Your Cake and Eat It Too: Accord and Satisfaction Survives the Uniform Commercial Code*, 61 N.D. L. REV. 353 (1985); W. Jack Grosse & Edward P. Groggin, *Accord and Satisfaction and the 1-207 Dilemma*, 89 COMM. L.J. 537 (1984); W. Jack Grosse & Edward P. Groggin, *The 1-207 Dilemma Revisited*, 16 N. KY. L. REV. 425 (1989); Arthur J. Rosenthal, *Discord and Dissatisfaction: Section 1-207 of the Uniform Commercial Code*, 78 COLUM. L. REV. 48 (1978).

73. § 1R-207(2).

74. § 3R-311 uses the term “person against whom a claim is asserted.”

at that place. The organization also avoids discharge by tendering repayment of the amount involved within 90 days after payment.⁷⁵ Furthermore, the claim is discharged if the claimant, or an agent with direct responsibility over the claim, knew before payment of the instrument that the instrument had been tendered in full satisfaction.⁷⁶

The drafters state that these rules follow the common law, “with some minor variations to reflect modern business conditions.”⁷⁷ In particular, they protect larger business organizations from inadvertent accord and satisfaction that might result from automatic check processing procedures, either by clerks or computers or both.⁷⁸

IX. ACCOMMODATION PARTIES AND SURETYSHIP

The rules on accommodation parties and suretyship in §§ 3-415, 3-416, and 3-606 have been clarified, modified, and expanded in §§ 3R-419 and 3R-605.⁷⁹ Although many suretyship defenses are commonly waived by express terms of promissory notes as a matter of standard commercial practice, occasions arise when such waiver provisions do not appear in the note or the creditor does not specifically obtain the permission of the accommodation party or surety to take the particular action on which the surety later bases her defense.⁸⁰

Of particular note is the Revision’s elimination of the “reservation of rights” doctrine. Under Article 3, if the holder of an instrument, without the surety’s consent, releases or agrees not to sue the debtor or agrees to an extension of time for payment, the surety is discharged unless the holder expressly reserves his rights against the surety.⁸¹ Moreover, it is not necessary for the holder to notify the surety of the reservation of rights.⁸²

Section 3R-605(b) states specifically that discharge of the debtor does not discharge an indorser or accommodation party with a right of recourse against the debtor. Furthermore, if the creditor grants to the debtor an extension of the instrument’s due date, the surety is discharged only to the extent she can prove that the extension caused loss to her with respect to her right of recourse.⁸³ If the creditor grants any other modification of the debtor’s obligation, the surety

75. § 3R-311(c).

76. § 3R-311(d).

77. *Id.*, cmt. 3.

78. *Id.*, cmt. 5.

79. For an in depth analysis of the Revision’s suretyship provisions, see Neil B. Cohen, *Suretyship Principles in the New Article 3: Clarifications and Substantive Changes*, 42 ALA. L. REV. 595 (1991). Prof. Cohen is the Reporter of the RESTATEMENT OF THE LAW (THIRD) SURETYSHIP. *Id.*

80. See § 3R-605, cmt. 2.

81. See § 3-606, and cmt. 4 thereto.

82. WHITE & SUMMERS, *supra* note 9, § 13-17. The authors note that there was a notice requirement in the 1952 Official Text, but it was deleted from the 1958 Official Text. *Id.* at note 7.

83. § 3R-605(c).

is discharged to the extent of any loss caused to her right of recourse as a result of the modification. However, the burden is on the creditor to prove that the loss was less than the full amount of the surety's recourse against the debtor.⁸⁴

If the creditor impairs any collateral which accompanies the instrument, the surety is discharged to the extent of the impairment.⁸⁵ Impairment of collateral is described as failure to perfect a security interest in it, release of collateral without obtaining a substitution, failure to preserve collateral in accord with Article 9, or failure to comply with applicable law in disposing of the collateral.⁸⁶ In a situation in which the obligors on an instrument each have a right of contribution against the other and one of them posts the collateral, impairment of the collateral will discharge a party to the extent that he must pay more than he would have had to pay, taking into account his right of contribution from the other party, had the collateral not been impaired.⁸⁷ The typical situation would be one in which co-makers sign a note, co-maker A posts collateral that the holder subsequently impairs, co-maker A becomes insolvent, and co-maker B must pay the entire debt. Had the collateral not been impaired by the holder, co-maker B would have had recourse to the collateral, at least for his share of the debt.⁸⁸

X. FRAUD, FORGERY, FICTITIOUS PAYEES, FAITHLESS EMPLOYEES, IMPOSTERS AND COMPARATIVE NEGLIGENCE

A frequent problem arising under Article 3 is what to do when a dishonest employee engages in one of several courses of conduct: (1) He supplies to his employer the names of fictitious or real payees with the intention of taking the checks after they are issued and indorses in the name of the named payees; (2) he steals checks payable to the employer and forges the employer's indorsement; or (3) he forges the employer's signature as drawer on the employer's own checking account.⁸⁹ Depending on the facts, application of the rules of Article 3 to these typical problems resulted in "winner take all," regardless of any negligence of the other party or parties.⁹⁰ Thus, in *M & K Corp. v. Farmers State Bank*,⁹¹ which involved checks drawn to the order of fictitious payees by employees with authority to sign checks, the court concluded that, pursuant to the plain language of § 3-405, indorsements in the names of the fictitious payees were effective, thereby precluding the employer from recovering the amount of

84. § 3R-605(d).

85. § 3R-605(e).

86. § 3R-605(g).

87. See § 3R-605(f).

88. See *id.*, cmt. 7.

89. See §§ 3-405, 3-406, 4-406; Donald J. Rapson, *Loss Allocation in Forgery and Fraud Cases: Significant Changes under Revised Articles 3 and 4*, 42 ALA. L. REV. 435 (1991).

90. See Rapson, *supra* note 89, at 458.

91. 496 N.E.2d 111 (Ind. Ct. App. 1986).

the checks from either the bank that cashed the checks or the drawee bank that paid them, notwithstanding the cashing bank's negligence in failing to request identification.⁹² The court noted that notwithstanding the harshness of strict application of § 3-405 to preclude consideration of the bank's negligence, the statute was plain and unambiguous and had been similarly interpreted in other jurisdictions.⁹³

Similarly, in *Indiana National Corp. v. FACO, Inc.*,⁹⁴ an employee who had no authorization to sign checks wrote 167 checks totaling \$51,800 to his own or his daughter's order and forged his employer's signature to the checks. The trial court found that the employer, in failing to examine the monthly bank statements or audit the account, had failed to exercise the care required under § 4-406(1) and (2) and would ordinarily have been precluded from demanding recredit of the checks to its account.⁹⁵ However, the trial court also found that the drawee bank was negligent in paying the checks and that, pursuant to § 4-406(3), the preclusion against the drawer's demand for recredit did not apply.⁹⁶ The court of appeals affirmed the findings of the trial court regarding bank negligence but remanded for deduction from the judgment amount the total of those checks written prior to the one year statutory bar of § 4-406(4).⁹⁷

The Revision has resolved the unfairness of both these results by adopting a comparative negligence standard. Under §§ 3R-404(d) and 3R-405(b), if the person paying or taking the instrument fails to exercise ordinary care and that failure "substantially contributes" to the loss involved, the party initially bearing the loss may recover "to the extent the failure to exercise ordinary care contributed to the loss."⁹⁸ Thus, the loss in the *M & K Corp.* case would be allocated between the employer, whose employees drew checks to fictitious payees and whose indorsements in the names of those payees were therefore

92. In addition to fictitious payees, some of the checks were drawn to the order of real payees but with the intention that those payees have no interest in the checks. *Id.* at 112. Under § 3-405(1)(b), the result is the same, *i.e.*, any indorsement in the name of the payee is effective. § 3-405(1)(b).

93. 496 N.E.2d at 114-15 (citing *Merrill Lynch, Pierce, Fenner & Smith v. Chemical Bank*, 442 N.E.2d 1253 (N.Y. 1982)). The court of appeals noted that a California case, *E.F. Hutton & Co. v. City Nat'l Bank*, 196 Cal. Rptr. 614, *reh. denied* (Cal. Ct. App. 1983), had ruled that a bank may be liable despite the language of § 3-405. However, the Indiana court concluded that this conflicted with the plain meaning of the statute. 496 N.E.2d at 113-15.

94. 400 N.E.2d 202 (Ind. Ct. App. 1980).

95. *Id.* at 205.

96. *Id.*

97. § 4-406(4) states:

Without regard to care or lack of care of either the customer or the bank a customer who does not within one (1) year from the time the statement and items are made available to the customer . . . discover and report his unauthorized signature . . . is precluded from asserting against the bank such unauthorized signature

98. §§ 3R-404(d), 3R-405(c).

effective, and the bank that negligently failed to demand any identification at the time it cashed the checks.⁹⁹

Under § 4R-406(d) and (e), although a customer, as a consequence of his own failure to examine his bank statements and to report forgeries in time to prevent loss to his bank, may be precluded from requiring his bank to recredit those checks, if he proves that his bank failed to exercise ordinary care and contributed to the loss, the loss will be allocated between them. Under this provision, the result in *Indiana National Corp. v. FACO, Inc.*, would be the allocation of the loss between the drawer and the drawee bank. The bar against recovery for forgeries more than one year old, regardless of either party's negligence, remains the same.¹⁰⁰

With respect to forged indorsements by an employee, whether the forgery is the employer's indorsement or the indorsement of another payee, the policy of the Revision, as codified in § 3R-405, is to place the loss on the employer, provided the employee was one entrusted with responsibility for checks and the bank was not negligent.¹⁰¹ The section "is based on the belief that the employer is in a far better position to avoid the loss by care in choosing employees, in supervising them, and in adopting other measures to prevent forged indorsements"¹⁰² In the event the employer can prove the bank failed to exercise ordinary care, thereby contributing to the loss, the loss will be allocated between the parties.¹⁰³

A further change that imposes liability on the party in the better position to avoid the loss appears in § 3R-404(a). Under § 3-405(1)(a), anyone could validly indorse a check or note in the name of the payee if the instrument was procured by an imposter who induced the maker or drawer to issue it to the order of the imposter or a confederate. However, the official comment thereto states that if the person procuring the check or note misrepresents his authority to act for a principal, the drawer or maker is entitled to have the genuine indorsement

99. It is interesting to note that early in the legislative process, some Indiana banking interests proposed an amendment to Senate Bill 197 (the Revisions) to delete the comparative negligence standard in §§ 3R-404 and 3R-405 and to codify the result in *M & K Corp.* See Memorandum from Indiana Bankers Ass'n to Indiana Senator Vi Simpson 3-4 (Feb. 12, 1993) (copy on file with the author).

100. See § 4R-406(f). It is of interest to note that the Indiana Bankers' Association did not object to the adoption of a comparative negligence standard in § 4R-406. See Memorandum from Indiana Bankers Ass'n, *supra* note 99, and the discussion therein. Had § 4-406(3) remained unchanged, negligent banks would remain liable for the full amount of loss despite customer negligence. It appears that the Association is willing to agree to a standard of comparative negligence only when it derives some benefit from that standard but not when the standard would impose some liability for bank negligence. Is this a case of the banks wanting their cake and their penny too?

101. § 3R-405, cmt. 1.

102. *Id.*

103. § 3R-405(b).

of that principal.¹⁰⁴ Section 3R-404(a), however, makes the indorsement effective if the imposter impersonates either the payee or a person authorized to act for the payee, *i.e.*, an agent, who obtains the instrument payable to the order of the alleged principal.¹⁰⁵

In *Insurance Co. of North America v. Purdue National Bank of Lafayette*,¹⁰⁶ the drawer was induced to issue two checks to the order of named payees by someone who represented that he was authorized to act on their behalf, but the drawer failed to make inquiry into his authority. The court concluded that the drawer was negligent in failing to investigate the authority of the alleged agent and that such negligence substantially contributed to the forged indorsements, thereby precluding the drawer from asserting the forgery pursuant to § 3-306.¹⁰⁷ Although this result seems equitable, it also appears to be contrary to the intention of § 3-405, as expressed in the official comment, which indicates that the drawer is entitled to protection if the check is drawn to the alleged principal. Under § 3R-404(a), however, the indorsements would be effective in any event because the imposter misrepresented that he had authority to act on behalf of the alleged principals. The ultimate result of the case would be the same, but it would be achieved without the court having to stretch its reasoning between two sections of the Code and resolving an apparent conflict between them.

XI. CHECK TRUNCATION AND THE DUTY TO EXAMINE BANK STATEMENTS

Two additional significant changes in the Revisions are the authorization of radical check truncation and the adoption of comparative negligence as the standard to be applied when the drawer negligently fails to examine his bank statement but the drawee bank is also negligent in paying the check. These two changes are interrelated because radical truncation eliminates the physical return of the checks themselves to the drawer or to the drawee bank, but in reviewing his statement, the drawer must have a sufficient amount of information to detect forgeries or alterations.

As the check collection system is envisioned under present Article 4, a typical transaction involves the deposit by the payee, the encoding of the amount of the check in the Magnetic Ink Character Recognition (MICR) line at the bottom of the check by the depository bank, the forwarding of the check to a collecting bank (either a Federal Reserve branch or a clearinghouse), and the presentment of the check for payment to the drawee or payor bank. In the process, the check itself moves through the system, but, after the encoding, no humans look at the check; its MICR line is read by the computers that handle the

104. See § 3-405, cmt. 2.

105. See § 3R-404(a) and cmt. 1 thereto.

106. 401 N.E.2d 708 (Ind. Ct. App. 1980).

107. *Id.* at 715.

check. If the drawee bank pays the check, the drawee includes the canceled check itself in the periodic statement to the drawer or makes the check available to the drawer.¹⁰⁸ The drawer then reconciles the returned checks against the check register. Drawee banks seldom make any comparisons between the drawer's signature as it appears on the checks and as it appears on the signature card on file.¹⁰⁹ Thus, the ultimate duty to detect a forged drawer's signature is actually on the drawer. If there are any irregularities (forged drawer's signature or alteration) with respect to the check, it is the drawer's responsibility to report these to the drawee bank within a reasonable time. If the drawer fails to do so, the drawer may be precluded from asserting that the forged or altered checks must be recredited by the drawee because they were not properly payable from the drawer's account. Moreover, if there are a series of forgeries by the same person, any forged checks paid within a period beginning fourteen days after the statement and checks are available to the drawer and ending when the drawer does complain need not be recredited to the drawer's account.¹¹⁰

The drawee's failure to compare signatures, as noted above, raises the issue of whether that failure is negligence, which under § 4-406(3) places full responsibility for the forged checks on the drawee regardless of the drawer's own failure to examine the bank statement as the earlier part of the same section requires. Some courts have held that indeed it does; others have held that it does not.¹¹¹

With standard truncation, the drawee bank merely retains the item and submits a report of paid checks to the drawer. With radical truncation, the depository bank keeps the check itself and forwards nothing more than an electronic signal via computer and modem. The drawee bank's computer determines whether or not to pay the check based on such things as the availability of funds in the drawer's account or the existence of any stop payment orders or attachments of the account. Neither the drawee bank nor the drawer ever see the check itself. This system of radical truncation obviously speeds up the collection process by eliminating the need to deal with billions of pieces of paper, many of which must physically travel long distances, perhaps over several days. Instead, the entire process may take no more than a few minutes of electronic interchange. However, current Article 4 places impediments in the way of radical truncation, particularly the requirement that a bank sending the statement to its customer either include or make available the canceled

108. See § 4-406(1).

109. See WHITE & SUMMERS, *supra* note 9, § 16-3, at 75 (Supp. 1993).

110. § 4-406(2).

111. Compare, e.g., *Medford Irrigation Dist. v. Western Bank*, 676 P.2d 329 (Or. Ct. App. 1984) (failure to compare signatures constitutes lack of ordinary care as a matter of law) with *Wilder Binding v. Oak Park Trust & Sav. Bank*, 552 N.E.2d 783 (Ill. 1990) (failure to compare is a question of fact dependent on banking usage); see WHITE & SUMMERS, *supra* note 9, § 16-3.

checks.¹¹² The drawee bank simply does not have those checks to send in a system of radical truncation.

Revised Article 4 facilitates the adoption of radical truncation in several provisions. First, it expressly authorizes banks to enter agreements “for electronic presentment . . . by transmission of an image of an item or information describing the item (‘presentment notice’) rather than delivery of the item itself.”¹¹³ In addition, “ordinary care” has been defined so as to eliminate the drawee’s examination of checks presented for payment by automated means, i.e., electronically, provided the bank follows standard banking practices.¹¹⁴ Finally, if the checks are not returned because of truncation, the bank at the point of truncation shall either retain the checks themselves or maintain the capacity to furnish legible copies for seven years. The drawee bank, however, must furnish sufficient information for the drawer to be able to reconcile her account, at a minimum, the item number, the amount, and the date of payment, and must provide either the check or a legible copy if requested by the drawer to do so.¹¹⁵ Furthermore, at the point of truncation, the bank that encodes and retains the check warrants that the check was encoded correctly and that the retention and presentment of the check comply with the electronic presentment agreement. If these warranties are breached, the injured party may recover for the loss suffered, plus expenses and interest.¹¹⁶

As with the former provision, the drawer is required to examine her bank statement or be precluded from asserting a forgery or alteration.¹¹⁷ The grace period for reporting serial forgeries by the same individual is extended from fourteen to thirty days. However, as noted earlier, if the drawer negligently fails to examine her bank statement but is able to prove that the bank failed to exercise ordinary care and that failure substantially contributed to the loss, the loss is allocated between them on a comparative fault basis rather than being placed entirely on the bank, as under the older provision.¹¹⁸ Moreover, the official comments note that a bank will not share the loss solely because it

112. § 4-406(1), discussed *supra* note 105.

113. § 4R-110(a); *see* § 4R-103.

114. § 3R-103(a)(7) states, in part,

[In the case of a payment] by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank’s prescribed procedures and the bank’s procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4.

This definition is expressly incorporated into Article 4 by § 4R-104(c).

115. § 4R-406(a), (b).

116. § 4R-209.

117. *Compare* § 4-406 with § 4R-406.

118. § 4R-406(e). *See* the discussion of the position of the Indiana Bankers’ Association on this issue, *supra* note 100.

follows automated collection and payment procedures (and failed to examine the signature).¹¹⁹

XII. POST-DATED CHECKS, OVERDRAFTS, PROPER PAYMENT, AND WRONGFUL DISHONOR

It has long been the rule that banks may only charge against a customer's account those items that are properly payable from the account.¹²⁰ It has also been the rule that although a check drawn against insufficient funds may be dishonored by the drawee, such a check is nevertheless properly payable if the drawee chooses to pay it.¹²¹ However, Article 4 gave no guidance as to what happens when the drawer deposits funds to cover a check originally drawn on insufficient funds after the drawee bank has determined the account to be insufficient, but prior to the bank's actual dishonor and return of the check, and whether the drawee bank must examine the account again prior to its midnight deadline before dishonoring the check.¹²² Section § 4R-402(c) provides that the drawee may examine the drawer's balance at any time between the presentment of the check and its return to the presenter and that the drawee need examine the account only once before deciding to dishonor. A dishonor for insufficient funds at that time is not wrongful even if the drawer deposits funds to cover the check before the bank's midnight deadline. If the bank does elect to reexamine the account, the balance at the time of reexamination controls, and the dishonor is wrongful if the account then contains sufficient funds.

It has also been the rule that a post-dated check is not properly payable until after its stated date, and that payment of such a check that depletes the drawer's account and causes other checks to be dishonored may result in drawee liability for wrongful dishonor.¹²³ Under current electronic processing procedures, however, the depository bank does not encode the date, and the drawee receives no notice in the presentment process that the check is post-dated and not properly payable. In order to facilitate electronic check processing procedures and to avoid imposing unreasonable burdens on drawee banks, § 4R-401(c) provides that a drawee bank may properly charge a post-dated check against the drawer's account unless the drawer notifies the bank that the check is post-dated, essentially in the same manner that the drawer would give the bank a stop-payment order under § 4-403.

Finally on the subject of overdrafts, if a checking account is jointly held and one authorized drawer writes a check that creates an overdraft, the other drawer

119. § 4R-406, cmt. 4.

120. See §§ 4R-401, 4-401.

121. *Id.*

122. See § 4R-402, cmt. 4.

123. See § 4R-401, cmt. 3.

is not liable for the amount of the overdraft unless she also signed the check or benefitted from the proceeds.¹²⁴

XIII. PRESENTMENT AND TRANSFER WARRANTIES AND A CASE OVERRULED

The original Code provisions that govern both warranties on the presentment of instruments for payment and warranties on the prior transfers of those instruments are §§ 3-417 and 4-207.¹²⁵ It would be generous to say that these sections are less than clear.¹²⁶ The Revisions have separated and clarified presentment and transfer warranties by separating the two types of warranties into distinct sections and by simplifying the language used in each.¹²⁷ The basic warranties themselves continue relatively unchanged. In particular, the rule of *Price v. Neal*,¹²⁸ that the drawee takes the risk of paying a draft bearing a forged drawer's signature, continues in full force.¹²⁹

One language change is of particular importance in Indiana because it overrules a position taken by the Indiana Court of Appeals. In *Insurance Co. of North America v. Purdue National Bank of Lafayette*,¹³⁰ two checks of the drawer were paid by the drawee bank despite the presence of forged indorsements. Rather than seek reimbursement from the drawee bank for making an improper payment, which would have been the appropriate course of action, the drawer (actually the drawer's insurance subrogee) pursued the collecting bank. One of the claims was breach of the presentment warranty of good title under §§ 3-417(1)(a) and 4-207(1)(a). The language of these sections gave the benefit of

124. § 4R-401(b), and the cmt. thereto.

125. § 3-417 applies to all presentments and transfers outside the bank collection system, whether the instruments are notes or drafts. § 4-207 applies to banks and bank customers within the bank collections system. As noted in the official comment to § 4-207, except for certain matters applicable only to bank customers and collecting banks, the two sections are identical in substance. §4-207, cmt. 1.

126. WHITE & SUMMERS characterize the two sections as "a mess." They continue, "[t]he language is dense and lawyers with the most adroit minds cannot understand them." WHITE & SUMMERS, *supra* note 9, §15-5 (Supp. 1993). Prof. Whaley agrees and comments about the presentment warranties of §3-417(1), "[I]f you don't know what it means when you read it, you'll never figure it out on your own." DOUGLAS J. WHALEY, PROBLEMS AND MATERIALS ON PAYMENT LAW 184 (3d ed. 1992). The drafters themselves conceded, "The former provision was difficult to understand The result was a provision replete with exceptions that could not be readily understood except after close scrutiny of the language." § 3R-417, cmt. 1.

127. See §§ 3R-416 (Transfer Warranties), 3R-417 (Presentment Warranties), 4R-207 (Transfer Warranties), 4R-208 (Presentment Warranties).

128. 97 Eng. Rep. 871 (K.B. 1762).

129. See §§ 3R-417(a)(3), and cmt. 3 thereto; 4R-208(a)(3). This is in accord with Indiana's express recognition of the rule of *Price v. Neal*. See *Payroll Check Cashing v. New Palestine Bank*, 401 N.E.2d 752, 755 (Ind. Ct. App. 1980). The rule continues in effect despite judicial and scholarly criticism over the years. See Whaley, *supra* note 126, at 313.

130. 401 N.E.2d 708 (Ind. Ct. App. 1980), discussed in connection with the imposter rule, *supra* in the text accompanying note 104.

the presentment warranty to “a person who in good faith pays”¹³¹ and to “the payor bank or other payor who in good faith pays.”¹³² The issue was whether a drawer, from whose account the checks were paid, is a “person” or “other payor” who pays. Noting that there was no case on point in Indiana and that there was a split in the decisions of other states, the court quoted extensively from, and adopted the reasoning of, *Sun 'N Sand, Inc. v. United California Bank*,¹³³ rejected contrary authority, and declared that the drawer is such a payor with a right of action for breach of presentment warranty.¹³⁴

The Revisions have been redrafted to provide that presentment warranties run only in favor of the drawee,¹³⁵ and the official comment expressly rejects the *Sun 'N Sand* rule that the warranty was also made to the drawer.¹³⁶ Both the language of the Revisions and of the official comment indicate clearly that breach of the presentment warranties may not be asserted by the drawer, that the *Insurance Company of North America* case should no longer be considered good law on this point, and that the only redress of an aggrieved drawer when a check is paid over a forged indorsement is against the drawee bank.

XIV. CONVERSION LIABILITY

The Code provision on conversion of instruments, § 3-419, has been roundly criticized as being poorly drafted with respect to identifying or failing to identify proper plaintiffs, proper defendants, the theory of recovery, or the measure of damages.¹³⁷ Section 3R-420 has remedied these problems. The theory of recovery is the law of conversion applicable to all personal property, and the measure of damages is presumed to be the face amount of the instrument but no more than the plaintiff's interest in it.¹³⁸ The proper plaintiff is the payee of the instrument or a subsequent holder; the drawer has no cause of action in conversion.¹³⁹ This position resolves a split in the jurisdictions in favor of the

131. § 3-417(1).

132. § 4-207(1).

133. 582 P.2d 920 (Cal. 1978).

134. 401 N.E.2d at 712-14. As noted in the earlier discussion of this case, *supra* notes 104 and accompanying text, the court also ruled that the failure of the drawer to investigate the authority of the person requesting the checks to act on behalf of the named payees was negligence on the part of the drawer so as to preclude it from claiming a right to recredit.

135. §§ 3R-417(a), 4R-208(a). An exception is when a draft is dishonored by the drawee and is then presented directly to the drawer or an indorser for payment. *See* §§ 3R-417(d); 4R-208(d).

136. § 3R-417, cmt. 2; *see* § 4R-208, cmt.

137. *See* WHITE & SUMMERS, *supra* note 9, § 15-4, in which the authors call it “a haphazard (critics might even say half-ass) codification;” § 15-5, in which they comment that what courts have done to § 3-419(3) “shouldn't happen to a dog;” and § 15-4 (Supp. 1993), in which they state that the existing provision “has many warts and blemishes that detract substantially from its beauty, if not its efficacy.”

138. § 3R-420(a), (b).

139. § 3R-420(a).

majority, which includes Indiana, that the drawer does not have a cause of action for conversion if a check is paid over a forged indorsement.¹⁴⁰ Rather, the drawer's action is against the drawee bank for paying a check that was not properly payable.¹⁴¹

Under § 3-419(3), much confusion arose as to whether and when the depository or other collecting banks were proper defendants in an action for conversion because of a forged indorsement. The section appears to have been drafted originally with the intention of requiring the conversion suit to be brought against the drawee or payor bank, with that bank then suing up the line for breach of presentment warranty. However, this course of action would frequently result in multiple lawsuits.¹⁴² Section 3R-420(c) permits the payee to bring suit against both the drawee bank that paid the check and the depository bank that took the check with the forged indorsement in the first place.¹⁴³

XV. FINAL PAYMENT AND RECOVERY PAYMENT BY MISTAKE

Sections 4-213 and 3-418, which dealt with final payment of checks and recovery of payments by mistake, created some confusion as to the circumstances under which banks could reverse entries before becoming accountable, *i.e.*, liable for the amount of checks and also recover mistaken payments.¹⁴⁴ Section 4R-215 has eliminated the process of posting the check to the drawer's account as a point marking final payment, thereby marking that point as only paying the item in cash, settling without a right to revoke, or allowing the midnight deadline to pass.

Section 3R-418 now provides that if a bank pays or accepts a check in the mistaken belief that no valid stop order existed or that the signature of the drawer was authorized, the bank may recover the payment or revoke the

140. See § 3R-420, cmt. 1, ¶ 2; *Insurance Co. of North America v. Purdue Nat'l Bank of Lafayette*, 401 N.E.2d 708, 710-11 (Ind. Ct. App. 1980) (discussed *supra* at note 130 and the accompanying text with reference to the cause of action for breach of warranty).

141. See §§ 3R-401, 3-401.

142. See WHITE & SUMMERS, *supra* note 9, §§ 15-5, 15-4 (Supp. 1992). In addition to the suits by the drawee bank, the payee from whom several checks may have been stolen would be required to sue each drawee bank rather than a single depository into which the thief is likely to have deposited the checks. Moreover, the depository bank is likely to be in the same jurisdiction as the payee whereas the drawee banks could be anywhere, thus making it more difficult for the aggrieved payee to obtain relief.

143. § 3R-420(c), and cmt. 3.

144. The confusion with respect to the time of final payment under § 4-213 apparently started with *West Side Bank v. Marine Nat'l Exchange Bank*, 155 N.W.2d 587 (Wis. 1968), in which the court held that a payor bank could reverse an entry of payment at any time before its midnight deadline despite the fact that all of the steps to complete the process of positing, one of the indicia of final payment, had apparently been taken. See Walter Malcom, *Reflections on West Side Bank: A Draftsman's View*, 18 CATHOLIC U. L. REV. 23 (1968). Also, see, *e.g.*, WHITE & SUMMERS, *supra* note 9, § 17-2 (Supp. 1993), in which the authors acknowledge their own change of position between the second and third editions of their text with respect to when mistaken payments may be recovered.

acceptance except as against a holder in due course or person who has otherwise changed her position. The Official Comment notes that this preserves the doctrine of *Price v. Neal*¹⁴⁵ that payment over a forged drawer's signature remains the responsibility of the payor or drawee since there usually is a holder in due course or person who has changed position in the chain of title.¹⁴⁶

XVI. CONCLUSION

The Revisions will go a long way to clarifying problems and issues which have arisen under the original versions of Articles 3 and 4. They are not cure-alls. Many of the commentators referred to throughout this survey have already pointed to problems and omissions that might have been resolved in the drafting process but, for one reason or another, were not. It remains for the courts to sort these problems out. Nevertheless, the changes, coupled with the extensive official comments, should be of considerable help in aiding courts and practitioners to understand the law of negotiable instruments.

One final comment. The orientation of the Revisions, as that of the original articles they replace, favors the financial and banking industries. Whatever protection there may be for bank customers, whether businesses or ordinary consumers, must come from other law. The goal of the revisers was to bring the banking and financial industries into the modern age of computer technology and to facilitate further developments as technology grows. Today, it appears that this goal has been achieved, if not perfectly, then reasonably well.

145. 97 Eng. Rep. 871 (K.B. 1762) discussed *supra* note 128 and accompanying text.

146. § 3R-418, cmt. 1.