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SOME PETTY COMPLAINTS ABOUT ARTICLE THREE

James J. White*

IN many ways Article Three of the Uniform Commercial Code (Code) is like a huge machine assembled by a mad inventor and comprised of assorted sprockets, gears, levers, pulleys, and belts. Few thoroughly understand all of the jobs which this machine is to perform; and a search through the reported cases suggests that the machine is either performing so efficiently that it commits no mistakes worth litigating or it is not performing at all.¹

In their study of the intricacies of Article Three, law students resemble persons climbing about on the machine—pulling its levers, testing its belts and pulleys, and trying the motor. At first they are baffled by it; then they are intrigued by the complementary relationships among the various working parts which become apparent only upon close examination. They see that the inventor was far from mad, yet they are frustrated because they cannot see the machine in action to find out whether the gears and belts, which look as if they might not function properly, can, in fact, perform as planned. The discussion that follows will point out some places where the design looks defective. None of my complaints are fundamental; each is petty at least in the sense that no cases have yet manifested difficulty in the operation of the machine. Indeed, the words that follow may be simply one more person's pulling on the levers and poking at the innards of the machine.

I. "HOLDER" UNDER THE CODE

"Holder" is one of the most important terms of art used in Article Three of the Code. It is the basis of the "holder in due course" chassis and it is an important part of other less significant conceptual structures.² In most cases one has little difficulty in determining whether

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1. To and including January 1, 1967, the U.C.C. Reporting Service has reported approximately 120 cases that arose in federal and state appellate courts under Article Three.

2. Some of these other less significant conceptual situations are found in U.C.C. § 3-603 (payment to a holder discharges the payor's liability); § 3-407 (holder's fraudulent and material alteration causes discharge but a nonholder's action has no

a person is a holder. There are at least two requirements which must be satisfied: he must have possession of the negotiable instrument and, when he received it, the instrument must have had certain words written upon its face or upon its face and reverse side³—words making it either a bearer instrument or payable to the order of the holder.

One ambiguity is whether there is a third requirement, namely that one have acquired possession by the process of "delivery." The Code defines delivery as a "voluntary transfer"⁴ and if such a delivery is necessary, no thief can be a holder. A second ambiguity is whether one making an indorsement must himself be a holder (or a holder's representative) in order to endow his transferee with the status of holder. Thus, if a thief is not a holder himself because he fails to meet any of the foregoing requirements, does it follow that no person who claims through his indorsement can be a holder?

A. *The Delivery Requirement*

The only person who will commonly come into possession of a negotiable instrument except by a voluntary transfer is a thief.⁵ It is elementary that a thief will not be permitted either to retain the proceeds from a stolen instrument or to sue on such an instrument, without regard to whether he successfully describes himself as a holder.⁶

such consequences); § 3-413 and § 3-414 (the drawer and indorser engaged to pay only "holders or indorsers"); § 3-504 (presentment can be made only "by or on behalf of the holder").

Except where otherwise indicated, all references herein are to sections in and comments to the 1962 version of the Uniform Commercial Code [hereinafter cited as U.C.C.].

3. Presumably one who takes an instrument which is incomplete on its face and completes it according to his authority is a holder of the instrument so completed. See U.C.C. § 3-115 and comment 3 to § 3-305. This seems to be the only exception to the rule that an instrument must have certain words on its face or on its face and reverse side at the time of the transfer for the transferee to qualify as a holder. One who is not a holder for the want of such words cannot transform himself into a holder merely by altering the instrument. Although the Code nowhere explicitly states such a rule, § 1-201(20) should be read to incorporate the pre-Code law which was to that effect. See notes 52 and 53 *infra*. Moreover, to give a nonholder the power to make himself into a holder by his own alteration would be inconsistent with §§ 3-407 (alteration) and 3-404 (unauthorized signatures), as well as with the general Code policy of affording protection to the obligors of order paper.

4. U.C.C. § 1-201(14).

5. Of course transfers of negotiable instruments by trustees in bankruptcy, in connection with sheriff's sales, and in other such instances, may be classified as involuntary. Whether the drafters intended these transfers to be so classified is not clear. Section 3-302(3)(a) contemplates that a person taking at a judicial sale or under legal process be a holder, but it gives no clue as to whether such taking should be deemed a voluntary transfer.

6. Irrespective of his status as a holder, the thief will be guilty of conversion and will be obliged to repay the owner. The owner's right against the thief arises not from

Therefore, the examination of the thief's status is important only because the rights and liabilities of subsequent transferees of the thief as well as other parties will sometimes depend upon whether the thief is a holder. Three situations illustrate this point:

(1) A dismissed employee steals a payroll check which had been made payable to his order. Whether the loss falls on his employer or on the thief's transferee will sometimes depend upon whether the thief is classified as a holder.⁷

(2) A thief steals a bearer check from the owner's hands and procures payment directly from the drawee bank. Whether the loss rests upon the drawee bank or on the owner from whom it was stolen will sometimes depend upon whether the thief is a holder.⁸

(3) A thief steals a \$500 bearer check and raises the amount to \$1,500. It is likely that \$1,000 of the loss will ultimately come to rest upon the thief's immediate transferee, but whether that transferee or some other person will bear the other \$500 loss will sometimes depend upon whether the thief is a holder.⁹

In each of the above hypothetical cases, the thief satisfies the "words" as well as the possession requirements and fails to be a holder, if at all, only because he does not take by delivery.

In the search for a delivery requirement, consider first section 1-201(20), the general definition of "holder": "'Holder' means a person who is in possession of a document of title or an instrument or an investment security drawn, issued or indorsed to him or to his order or to bearer or in blank." This definition contains no explicit reference to delivery or other voluntary transfer, but its three verbs—"drawn, issued or indorsed"—may incorporate such a term. "Issue" is defined in section 3-102(1)(a) which states that it is "the first de-

the Code but from the common law as incorporated by § 1-103. Although § 3-419 does deal with the conversion liability of certain persons, it is most unlikely that the Code drafters intended to extinguish the common law liability of the thief by their codification of the bank's responsibility in § 3-419. See U.C.C. § 3-419(1)(c) and NEW YORK LAW REVISION COMM'N, 2 REPORT ON THE UNIFORM COMM. CODE [320] (1982) (1955).

7. See notes 27 and 28 *infra* and accompanying text.

8. See notes 29 and 30 *infra* and accompanying text.

9. Subsequent transferees of the altered instrument can transfer at least \$1,000 of the loss to the thief's transferee on the basis of the latter's breach of his warranty concerning alteration under § 3-417. Unless he can recover from the thief, this \$1,000 loss will rest with the thief's transferee.

The question whether the other \$500 of the loss will rest on the thief's transferee, the drawer, or on another party is discussed in notes 31 and 32 *infra* and accompanying text.

livery . . ." of an instrument.¹⁰ "Indorse" is defined only indirectly under section 3-202(2)¹¹ which contains no requirement of delivery. "Draw" is not defined in the Code, and the principal question is whether a delivery requirement is implicit in the word.

A comparison of the status of a thief of a bearer check with that of a thief of a bearer note suggests why one might imply such a requirement. If "drawing" is no more than a drawer's act of signing the check, the check thief is a holder, for he is one in possession of an instrument "drawn, issued or indorsed" to bearer. But the same is not true of the thief of the bearer note. The note has not been "issued" since there has been no delivery, and it has not been "indorsed." It is difficult to say that the note has been "drawn" to bearer because "draw" is used elsewhere in the Code to refer only to drafts; indeed the authors of the Code have carefully distinguished "drawing" a draft from "making" a note and have consistently used both words when they intended to refer to both items.¹² The note thief therefore does not fit comfortably under any of the three verbs in section 1-201 and consequently appears to be a nonholder. This logic leads to the conclusion that the thief who makes one dip into the cash drawer is a holder of the bearer checks he comes up with, but is a nonholder as to any bearer notes he retrieves. Surely, there is no reason for so distinguishing between these two cases, especially when one considers the effect which this arbitrary classification will have for the parties to these two kinds of instruments. The two cases can be harmonized either by reading a delivery requirement into the term "draw" or by stretching "draw" so as to include the act of making a note and not reading in a delivery requirement. Under the former approach the check thief would claim under the verb "draw" and the note thief would claim under the verb "issue"; neither would be a holder since each would lack the required delivery. Under the latter approach both would claim under "draw," and both would be holders. Thus, if one is to avoid indefensible results under section 1-201(20) itself, he must either imply a delivery requirement in the verb "draw" or he must use that word in a way in which it is not used elsewhere in the Code.

The question would be simple enough if section 1-201(20) were

10. This definition is explicitly applicable only to Article Three, but there is no reason to believe that the drafters of the Code would have intended "issue" to mean one thing where it appears in Article Three and another thing in § 1-201(20) as that section is applied to Article Three transactions.

11. For a discussion of the question whether § 3-202(2) provides a definition of the verb "indorse," see text accompanying notes 35-39 *infra*.

12. See, e.g., §§ 3-413, 3-417, & 3-405.

the only relevant section. However, section 3-202(1)¹³ (concerning "negotiation") also bears upon the question of who is a holder; its first sentence states that "[N]egotiation is the transfer of an instrument in such form that the transferee becomes a holder." This sentence can be read in two ways: it might mean that negotiation is the *only* way of becoming a holder; or it might mean only that negotiation is *one* of the ways in which one becomes a holder. Comment 1 to section 3-202 hints at the former interpretation by stating that negotiation is "merely a special form of transfer *the importance of which lies entirely in the fact that it makes the transferee a holder* as defined in § 1-201" [Emphasis added]—a fair paraphrase of which might be: "this section's purpose is to define 'holder.'" If one so construes the first sentence of section 3-202 and the quoted comment to mean that the process of negotiation is the *exclusive* method by which one becomes a holder, then he has a second and self-sufficient way of defining "holder." Unlike section 1-201(20), it contains no internal ambiguity, for it explicitly requires a delivery for a negotiation to occur.

Whether the drafters of the Code intended negotiation to be the exclusive method by which one becomes a holder is not clear. Under the Negotiable Instruments Law (NIL), some courts held that the initial transfer of an instrument was not a "negotiation" but only an "issue";¹⁴ other courts held that it was a negotiation.¹⁵ One might infer from the retention of the word "issue" in the Code that the drafters did not intend to classify the original transfer of an instrument as a negotiation, and the removal of the word "negotiation" from the provisions dealing with holders in due course for the stated purpose of enabling the payee to be a holder also lends support to this interpretation.¹⁶ If the drafters had intended to make the original

13. Section 3-202(1) reads as follows:

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.

14. See, e.g., *Williamson v. Payne*, 300 Ky. 161, 188 S.W.2d 96 (1945); *Firestone Tire and Rubber Co. v. Central Nat'l Bank*, 159 Ohio St. 423, 112 N.E.2d 636 (1953); *Britton Milling Co. v. Williams*, 44 S.D. 464, 184 N.W. 265 (1921).

15. See, e.g., *Macklin v. Macklin*, 315 Mass. 451, 53 N.E.2d 86 (1944); *First Nat'l Bank v. Noble*, 179 Ore. 26, 168 P.2d 354 (1946); cf. *Kohler v. First National Bank*, 157 Wash. 417, 289 Pac. 417 (1930).

16. Section 52 of the UNIFORM NEGOTIABLE INSTRUMENTS LAW [hereinafter cited as N.I.L.] provided:

A holder in due course is a holder who has taken the instrument under the following conditions:

4. That at the time it was negotiated to him he had no notice of any infirmity (Emphasis added.)

Comment 2 to § 3-302 states that the word "negotiated" in § 52(4) of the NIL has caused "conflict over the status of the payee as a holder in due course," and that the

transfer a negotiation, removing the word from section 3-302 would have been unnecessary. Furthermore, by adding a word or two in section 3-202, the drafters easily could have made negotiation the exclusive method of becoming a holder, but they did not do so. These facts suggest that the drafters did not characterize the original transfer as a negotiation, but nevertheless intended the first transferee to be a holder; accordingly, they support the conclusion that negotiation (with its attendant "delivery") is not the exclusive means by which one can become a holder.

On the other hand, the second sentence of section 3-202(1) seems to support the contrary conclusion. That sentence states: "If the instrument is payable to order it is negotiated by delivery *with any necessary indorsement . . .*" (Emphasis added.) One can argue that the drafters intentionally used the qualifying adjective "necessary" and purposely deviated from the antecedent NIL language ("If payable to order it is negotiated by the indorsement of the holder completed by delivery")¹⁷ in order to indicate that the original transfer is a negotiation despite the absence of an indorsement. Unless the original transfer is a negotiation, an indorsement is *always* necessary for the negotiation of an order instrument to occur.¹⁸ If an indorsement is *always* necessary, then the qualifying adjective is superfluous;¹⁹ therefore, the argument goes, in order to give meaning to the adjective "necessary," the original transfer must be a negotiation. It does not necessarily follow from the fact that the drafters may have expanded "negotiation" to include the original transfer (whose status was doubtful under the NIL) as well as all other standard transfers in which the transferee would be a holder, that they intended negotiation to be the exclusive means of becoming a holder, but it makes that conclusion possible, if not inviting.

Thus, one leaves section 3-202 unenlightened. As has been shown, the section can be read as a second and self-contained definition of the word "holder," which requires acquisition by delivery, and thus

word has been removed from § 3-302 to make it clear that a payee may be a holder in due course.

If, as suggested above, the drafters intended to make negotiation the exclusive way of being a holder by redefining it to include the original transfer, it would not have been necessary to remove the word "negotiation" from § 3-302. Nevertheless, the drafters may have done so out of an excess of caution.

17. N.I.L. § 30.

18. U.C.C. § 3-204(1).

19. The word "necessary" is not used to exclude bearer paper, for the quoted clause deals only with order paper. Nor is the word needed to tell which indorsements are proper and effective and which are not, for subsection (2) performs that function by defining "indorsement."

denies the status of holder to the thief. If that is so, section 3-202 is in apparent conflict with section 1-201(20). On the other hand, section 3-202 may be illustrative only and may not be intended to exclude other processes by which one can become a holder.

A final provision in Article Three which relates to the requirement of a delivery is comment 3 to section 3-305. It states that non-delivery of an instrument is a defense to an action on the instrument, but that a holder in due course takes the instrument free from any such defense.²⁰ If one concludes that only a holder can effectively indorse, and if delivery were required to make one a holder,²¹ it would be impossible for the situation suggested by the comment ever to arise with respect to an order instrument, namely: nondelivery of an order instrument (as, for example, theft of it) followed by a transfer to a person who is deemed a holder in due course of that instrument.²²

The argument that this comment negates the existence of a delivery requirement can best be understood in the context of an example. Assume that A draws a payroll check to the order of B but does not deliver it. B steals the check and transfers it to C who takes for value and without knowledge of the theft. The argument for the proposition that delivery from A to B is not a requirement for C's being a holder is as follows: (1) comment 3 to section 3-305 contemplates the possibility that C (bona fide purchaser) be a holder of the order instrument despite B's theft of it; (2) C (bona fide purchaser) can never be the holder of an order instrument under section 1-201(20) unless it is "indorsed" to him or his order; (3) only a holder can effectively "indorse";²³ (4) therefore B (the thief) must be a holder; (5) if delivery is a requirement for becoming a holder, B (the thief) will

20. Section 3-305, comment 3, reads in part as follows:

"All defenses" includes nondelivery, conditional delivery or delivery for a special purpose. Under this Article such nondelivery or qualified delivery is a defense (Sections 3-306 and 3-307) and the defendant has the full burden of establishing it. Accordingly the "conclusive presumption" of the third sentence of the original Section 16 is abrogated in favor of a rule of law cutting off the defense.

The effect of this section, together with the sections dealing with incomplete instruments (§ 3-115) and alteration (§ 3-407) is to cut off the defense of nondelivery of an incomplete instrument against a holder in due course

21. A necessary premise for the statement is that a nonholder of order paper lacks the power to convert it into bearer paper. For a discussion of a nonholder's power to change his own status by alteration see note 3 *supra*.

22. A similar ambiguity existed under the NIL. Section 16 contained the following language: "Where the instrument is in the hands of a holder in due course, a valid delivery thereof by all parties prior to him so as to make them liable to him is conclusively presumed." If delivery is a prerequisite to being a holder, how can one become a holder in due course and so raise the conclusive presumption?

23. See notes 33-47 *infra* and accompanying text.

never be a holder; (6) therefore delivery is not a requirement for one to be a holder.

The weakness in the foregoing logic lies in statement (1)—the conclusion that the comment contemplates an *order* instrument. Perhaps the comment refers only to bearer and incomplete instruments.²⁴ If so, there is no logical inconsistency in finding that the thief is a nonholder due to a lack of delivery and concluding that a subsequent transferee is a holder, because the transferee of a bearer instrument depends only upon possession, not "indorsement," to become a holder. A nonholder may not be able to "indorse," but he is able to deliver possession. However, this rejoinder—reading the comment as applicable only to bearer situations—is not entirely convincing. On its face, the comment is not limited to bearer instruments and thus could be read to apply to subsequent transferees of stolen order instruments.²⁵ Indeed, the drafters may have been thinking specifically of the stolen payroll check case.

The foregoing probing of sections 1-201 and 3-202, and the comment to section 3-305 leaves one in a state of exasperation and confusion.²⁶ On its face section 1-201(20) appears not to require a delivery for one to become a holder, yet if "issue" is to apply at all and if it is to have the definition which it has elsewhere in Article Three,

24. Comment 5 to § 3-115 suggests that the drafters had incomplete instruments in mind:

A holder in due course sees and takes the same paper, whether it was complete when stolen or completed afterward by the thief, and in each case he relies in good faith on the maker's signature. The loss should fall on the party whose conduct in signing blank paper has made the fraud possible, rather than upon the innocent purchaser. The result is consistent with the theory of decisions holding the drawer of a check stolen and afterwards filled in to be estopped from setting up the nondelivery against an innocent party.

25. Another portion of the comment dealing with the unavailability of "conditional delivery" as a defense against a holder in due course is equally applicable to order as to bearer paper. Holders in due course of order paper successfully defeated the conditional delivery argument in each of the following pre-Code cases: *Hussey v. Rappaport*, 127 F. Supp. 144 (D. Minn. 1954); *Colonial Discount Co. v. Sebel*, 19 N.Y.S.2d 661 (Sup. Ct. 1940); *Early v. Citizens Bank*, 173 Va. 436, 3 S.E.2d 167 (1939).

26. It should be noted that § 3-306 may also be relevant to our inquiry about the thief's status. One can argue that the language of § 3-306(d) implies that a thief can be a holder:

Unless he has the rights of a holder in due course any person takes the instrument subject to

- (d) the defense that he or a person through whom he holds the instrument acquired it by theft, or that payment or satisfaction to *such holder* would be inconsistent with the terms of a restrictive indorsement.

... (Emphasis added.)

The argument would be as follows: The term "such holder" refers to "a person" who "acquired [the instrument] by theft"—that is, a thief. However, consideration of comment 5 to § 3-306 together with §§ 3-603 and 3-306 suggests that "such holder" does not have reference to a thief, but to any holder who has taken under a restrictive indorsement. The confusion results from the poor sentence structure in § 3-306(d).

there would be a requirement for a delivery as to any person who claims under the "issue" language. Section 3-202 requires a delivery for a negotiation, but it is unclear whether the drafters intended negotiation to be the exclusive method by which one could become a holder. The comment to section 3-305 suggests that one can be a holder despite the fact that he took without delivery, but not even that is completely clear.

Faced with this mess, a judge will be free to do as he pleases. To determine what he should do, consider again the three problem situations suggested above:

(1) A dismissed employee steals the payroll check which was made out to his order but which was never delivered to him. The check itself will give no clue that it was not delivered or that it is different in any respect from the other payroll checks which the employee may have been properly receiving and cashing during a course of employment. If one follows the apparent Article Three scheme of allocating loss to the person with the greatest power to prevent recurrence of the loss, it is appropriate to use the analogy of section 3-405 in the padded payroll case and place the loss on the drawer-employer.²⁷ To do so, the thief must be held to be a holder.²⁸

(2) In the second case a thief of a bearer instrument procures payment directly from the drawee bank or the maker. If the instrument had instead been passed by the thief to a bona fide purchaser who then presented it to the bank or maker, payment to the purchaser as

27. Apparently because of the employer's ability to prevent payroll padding and because of his fault at failing to do so, the drafters have decided that the loss should be placed on him when paychecks are issued to fictitious employees. See the first paragraph of comment 4 to § 3-405:

4. Paragraph (c) is new. It extends the rule of the original Subsection 9(3) to include the padded payroll cases, where the drawer's agent or employee prepares the check for signature or otherwise furnishes the signing officer with the name of the payee. The principle followed is that the loss should fall upon the employer as a risk of his business enterprise rather than upon the subsequent holder or drawee. The reasons are that the employer is normally in a better position to prevent such forgeries by reasonable care in the selection or supervision of his employees, or, if he is not, is at least in a better position to cover the loss by fidelity insurance; and that the cost of such insurance is properly an expense of his business rather than of the business of the holder or drawee.

28. If the payee's signature in the stolen payroll case is treated as a forgery, then the loss will ultimately rest upon the person who cashed the check, on account of his warranty or indorsement liability. This is so because, if the thief and his transferees are not holders, the payment to them will not cause discharge of the indorsement contracts under § 3-603.

However, if the thief is held to be a holder, payment by the drawer through the drawee will be a discharge under § 3-603. Then, under § 3-601(3)(b), the bank's payment would also discharge the liability of any indorsee who "cashed" the check and the loss would rest on the employer or his insurer. To achieve the result of placing the loss on the employer in this case it will also be necessary to find that the one presenting the instrument for payment has "good title" under § 3-417(1)(a) and thus does not breach his warranty under that section.

a holder would have discharged the instrument and the underlying liability, and would have left the loss on the one from whom the check was stolen.²⁹ Such a result would reflect the policy that bearer instruments are first cousins of cash and should receive similar treatment. There is no reason why the same result should not follow if the bank or maker pays the thief instead of the thief's transferee. When the thief himself procures payment, the policy is the same and neither the culpability of the payor nor that of the thief's victim, nor the ability of either of them to prevent recurrence, differs from the case in which the instrument passes through one more set of hands before payment. To achieve this result, the thief must again be held to be a holder, for only payment to a holder so discharges the obligation under section 3-603. If no such discharge is effected, the loss will likely come to rest on the drawee of the check or the maker of the note.³⁰

(3) The third case is more difficult since here the thief has committed a "material and fraudulent" alteration by raising the check from \$500 to \$1,500. If he is held to be a holder, his alteration has the effect under section 3-407 of discharging all parties whose contracts are altered from all claims except for those asserted by a "subsequent holder in due course," who may enforce the instrument according to its original tenor. However, if the thief is not a holder, this alteration causes no discharge of any party. It is here desirable that the thief *not* be held to be a holder so that the parties will be held to their original obligations and so that a result similar to that achieved under the spoliation doctrine might be obtained. The "spoliation" doctrine, a traditional exception to the general rule that alteration causes discharge, was designed to prevent unwarranted discharges and windfalls which could result from such discharges.³¹

29. The transferee of a stolen bearer instrument can and often will be a holder in due course. Moreover he will have "good title." Thus payment made to him will discharge the liabilities on the instrument under § 3-603, and he will not be in breach of any of the presentment warranties under § 3-417. The discharge on the instrument also discharges any underlying obligation. U.C.C. § 3-802(1)(b). This will serve to throw the loss back upon the person from whom the instrument was stolen.

30. Because the item will not be "properly payable" (§ 4-401), the drawee bank will not be permitted to charge the drawer's account and the loss will rest upon the bank. For cases holding that a drawee bank may not charge the drawer's account for payments to nonholders at least in forgery cases, see *Los Angeles Inv. Co. v. Home Sav. Bank*, 180 Cal. 601, 182 Pac. 293 (1919); *Miami Beach First Nat'l Bank v. Edgerly*, 121 So. 2d 417 (Fla. 1960); *Wormhoudt Lumber Co. v. Union Bank & Trust Co.*, 231 Iowa 928, 2 N.W.2d 267 (1942); *Jordan Marsh Co. v. National Shawmut Bank*, 201 Mass. 397, 87 N.E. 740 (1909). Except for the foregoing cases, a search did not disclose cases dealing with the explicit question whether payment to a nonholder was "proper."

31. In *Walsh v. Hunt*, 120 Cal. 46, 53, 52 Pac. 115, 117 (1898), the court gives the rationale of the spoliation doctrine as follows:

The general rule undoubtedly is, as contended for by appellant, that any

Thus, in order to reach the most desirable results under the present language of the Code, the courts would have to make the thief into a holder in the case of the stolen payroll check and in the case of payment to the thief presenting a bearer instrument, but it would have to find him a nonholder in the alteration case. Under the present language of the Code, there is no satisfactory escape from this unpleasant inconsistency. Moreover, there are no cases or other data to indicate with certainty which of the three problems most warrants attention and solution. Absent such data, I would suggest that the courts find that delivery is *not* necessary for one to become a holder. This would facilitate satisfactory outcomes in the first two situations since the thieves could then be holders. Many, if not most, of the cases in which an instrument is altered by a thief can be satisfactorily resolved by a proper reading of section 3-201, irrespective of the thief's status.³² To the extent that such cases cannot be resolved in

material alteration in the contract avoids it, even in the hands of innocent holders, and prevents recovery upon it to any extent. But this rule has application to cases where such alteration has been made by the payee or party seeking to enforce it. By the later authorities the rule does not apply in cases where the alteration is by a stranger to the contract, and it is now the settled doctrine, in this country at least, that such an act by a stranger, without the privity of the grantee or obligee, does not avoid the contract in its entirety, even though it be without the knowledge or consent of the party to be bound, but amounts to a spoliation merely, which will not prevent a recovery upon the contract in accordance with its original terms, where those terms can be ascertained. And this is obviously upon the principle that the act of a mere interloper without the privity of the parties should not be permitted to defeat a contract to the extent that it would otherwise be valid and binding. (See Am. & Eng. Ency. of Law, 2d ed., 214, where the authorities are fully collated.) And an agent without authority is in this sense held to be a stranger to the transaction. . . .

For other cases which apply the spoliation doctrine see *Andrews v. Calloway*, 50 Ark. 358, 7 S.W. 449 (1887); *Bercot v. Velkoff*, 111 Ind. App. 323, 41 N.E.2d 686 (1942); *Francis v. Hughes*, 217 Miss. 377, 64 So. 2d 351 (1953); *Cooper v. Hembree*, 194 Okla. 465, 152 P.2d 695 (1944).

It is clear from comment 3(a) to § 3-407 that the drafters of the Code explicitly accepted the spoliation doctrine:

A material alteration does not discharge any party unless it is made by the holder. Spoliation by any meddling stranger does not affect the rights of the holder. It is of course intended that the acts of the holder's authorized agent or employee or of his confederates, are to be attributed to him.

If one is discharged from his liability on the instrument by § 3-407 or otherwise, § 3-802 provides that he is also discharged from the underlying obligation. Thus, if a person pays for a purchase by giving an instrument which is lost, found, and altered by the finder, and if such alteration caused a discharge, the purchaser would have perfectly good merchandise for which he did not have to pay and the seller would have no cause of action against anyone except perhaps the finder. The error in completely discharging the drawer in this circumstance is clear.

32. If § 3-201 were read to give each transferee of the subsequent holder in due course the same rights the subsequent holder in due course has, then any earlier party could pay the subsequent holder in due course and, by assuming his "special subsequent holder in due course" status, could sue earlier parties despite the alteration. This reading of § 3-201 would produce a fair result in all cases except those in which there was no such subsequent holder in due course. If, for example, parties subsequent to the alteration did not become holders in due course because they were put on notice

this manner, a court could quite properly redefine "holder" for the purposes of section 3-407 so as to exclude a thief on the theory that the drafters of the Code intended such a result when they incorporated the spoliation doctrine into that section.

The undesirability of so defining one word in two different ways is obvious and the suggested solution is therefore merely an interim answer. The ultimate solution of the difficulties caused by the ambiguity in the definition of "holder" and the harmonizing of the various Code sections lies in a revision of the Code.

B. Indorsement by Whom

A second ambiguity in the Code's definition of "holder" is whether one who is neither a holder nor a holder's agent but who nevertheless has possession of an order instrument can ever endow his transferee with the status of holder. This question will usually arise when an order instrument has been stolen and transferred.³³ In such a case, the thief's transferee will probably satisfy the possession and "words" requirement of section 1-201(20), for the thief will have delivered possession and will have placed the appropriate words on the reverse side of the instrument. The transferee will also satisfy any delivery requirement that may exist, for the thief will have voluntarily transferred the instrument to him. If the transferee fails to be a holder under section 1-201(20), therefore, it must be only because the instrument has not been "indorsed" to him or his order.³⁴

The definition sections in Articles One and Three contain no

by the alteration itself, then they could not sue even as to the original tenor and the entire loss would rest upon the thief's immediate transferee (if recovery could not be had from the thief).

A slightly different analysis of § 3-201 in the context of the alteration problem discussed in the text has been put forth in a student note. See 19 OKLA. L. REV. 179 (1966). There it was suggested that a subsequent holder in due course of an altered instrument under § 3-407 can select one among a group composed of prior indorsees and the drawer and, by suing the one he chooses, cause the loss to remain on that one. However, implicit in this approach is the assumption that the alteration has discharged all parties except with respect to one suit by the one specific subsequent holder; this overlooks the effect of § 3-201, which states that any transferee has the same rights as his transferor.

33. In such cases the thief will usually fail to be a holder himself because of the "words" requirement, that is, the document will be payable to the order of another, not payable to his order. Moreover, if delivery is a *sine qua non* to the status of holder, all thieves will also fail to be holders because of the lack of delivery.

34. In these cases we are concerned with the second and subsequent transfers of an instrument. By definition the verb "issue" is limited to the initial transfer. Although "draw" is not defined, it apparently refers to the "drawer's" act of signing (and perhaps delivering) a "draft," and does not refer to any subsequent transfer of a draft. Therefore, the only word left in § 1-201(20) upon which a person in our hypothetical can rely in order to be a holder is "indorsed."

definition of "indorse" or "indorsement."³⁵ The nearest thing to a definition of "indorsement" is found in section 3-202(2), which provides that an indorsement must be written "*by or on behalf of a holder*."³⁶ If that section defines "indorse" as it is used in section 1-201(20), then the transferee of an instrument who traces his title through the purported indorsement of a nonholder (thief or otherwise) is not a holder, for such a signature is not an "indorsement" within the meaning of the Code. Since each successive transferee fails to be a "holder" for want of an "indorsement," he also lacks the power to "indorse" under the Code and so fails to make his transferee a holder.

If section 3-202(2) provides the definition of "indorsement" and "indorse," one can properly ask why it is not appropriately captioned and placed in one of the definitional sections of the Code.³⁷ One can also argue, that section 3-202(2) defines only those "indorsements" necessary for negotiation to occur, and as argued above, that negotiation is not the exclusive method by which one becomes a holder. However, even if a court were persuaded by these arguments that section 3-202(2) is not a general definition which limits the power of "indorsement" to holders and their representatives, the court would not likely find a standard forger's transferee to be a holder. The logic of the Code dictates such a result, for making the forger's transferee a holder would give him the power to cause discharge under section 3-603 by procuring payment and to assume the rights of a holder in due course under section 3-305. This would throw the various parts of the Article Three machine quite out of harmony with one another—for instance, the bank's payment would at one and the same time be a discharge of its obligation and a conversion.³⁸ Certainly the drafters did not intend such an occurrence.³⁹

35. The definitional section in article 1 is § 1-201; that in article 3 is § 3-102.

36. Section 3-202(2) reads as follows: "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."

37. This particular arrangement of § 3-202 probably stems from the fact that it was patterned after an NIL provision which had similar words arranged under a "negotiation" heading. N.I.L. §§ 30-32. Moreover, the need for a separate definition may never have occurred to the drafters, for the courts had no trouble under the NIL denying a recovery to a forger's transferee. See, e.g., *United States v. Lemons*, 67 F. Supp. 985 (1946); *Berger v. Georgia Power Co.*, 77 Ga. App. 672, 49 S.E.2d 668 (1948); *Buena Vista Loan & Sav. Bank v. Stockdale*, 56 Ga. App. 168, 192 S.E. 246 (1937); *Fidelity Nat'l Bank v. Vuci*, 224 La. 123, 68 So. 2d 781 (1953); *Hellman v. Cornett*, 137 Va. 200, 119 S.E. 74 (1923).

38. Section 3-419(1)(a) states that one converts an instrument if he pays "on a forged indorsement," yet § 3-603 states that one's obligation is discharged by payment to a holder.

39. See comment 3 to § 3-417 and § 3-419.

There is, however, one quite elegant forgery situation in which a court might be tempted to find the forger's signature sufficient to make his transferee a holder. This is the so-called *Wells Fargo* situation,⁴⁰ in which a thief steals an order check, replaces the payee's name with his own or otherwise alters it, procures the drawee's acceptance, and then passes the check to a purchaser for value who presents it for payment. Under the NIL, two courts⁴¹ held that the accepting bank had to pay the presenter despite the fact that he traced his title through a thief, and, in dictum, both of these courts found that the presenter was a holder in due course.⁴² Comment 5 to section 3-417 of the Code cites both of these cases and states that section 3-417 is intended to produce the same results.⁴³ It purports to do so by creating an exception to a standard presenter's warranty which would otherwise throw the loss back on the presenter.⁴⁴ However, this exception, necessary to produce the *Wells Fargo* outcome, applies only to a presenter who is a "holder in due course." If the presenter is not a holder in due course, he does not get the benefit of the exception; he thus makes the warranty that the instrument has not been altered, and the loss may be thrown back upon him by the bank on grounds of breach of his warranty against alteration. Thus, if a court is to produce the *Wells Fargo* result under the Code in the way the drafters suggested, it must make the presenter into a holder despite the fact that he claims through a thief's signature.

40. *Wells Fargo Bank & Union Trust Co. v. Bank of Italy*, 214 Cal. 156, 4 P.2d 781 (1931). The inconsistency between the *Wells Fargo* outcome and § 3-417 of the Code has been noted previously. See Palmer, *Negotiable Instruments Under the Uniform Commercial Code*, 48 MICH. L. REV. 255, 295-99 (1950); 32 TEMPLE LAW Q. 182, at 188-90 (1959).

41. *Wells Fargo Bank & Union Trust Co. v. Bank of Italy*, *supra* note 40; *National City Bank v. National Bank*, 300 Ill. 103, 132 N.E. 832 (1921).

42. In *National City Bank v. National Bank*, *id.* at 108, 132 N.E. at 833, the court observed:

When appellant took the draft it was complete and regular on its face. It had been duly accepted by the drawee. It was taken in good faith and for value, and appellant then had no notice of any infirmity in the instrument or defect in the title of the person negotiating it, and appellant was therefore a holder in due course. It relied upon the general acceptance of appellee, and under the Negotiable Instruments Law was protected by it.

See also *Wells Fargo Bank and Union Trust Co. v. Bank of Italy*, 214 Cal. 156, 162, 4 P.2d 781, 784 (1931).

43. Comment 5 to § 3-417 reads as follows:

The exception made by subparagraph (iii) in the case of a holder in due course of a draft accepted after the alteration follows the decisions in *National City Bank of Chicago* . . . and *Wells Fargo Bank* . . . and is based on the principle that an acceptance is an undertaking relied upon in good faith by an innocent party. . . .

44. The exception mentioned in comment 5 is found in § 3-417(1)(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" (Emphasis added.)

For reasons discussed above, courts will not wish to make "holders" out of the transferees of mine run forgers; therefore, if courts are to reach the *Wells Fargo* result, they must distinguish transferees of checks carrying forged indorsements from transferees of checks on which material alterations in the payees' names or otherwise have occurred and on which the names (changed or not) have been "indorsed." The takers of the latter instruments would be holders but the takers of the former would not. However, this distinction between transferees of forged checks and those of altered or altered and forged checks is not supported by any apparent policy,⁴⁵ and it is difficult to justify under the language of the Code. The forger's transferee is not a holder because he takes under the signature of a nonholder-thief—one without power to "indorse" under section 1-201(20). But the same is true of the transferee in the *Wells Fargo* situation, for there the thief is a nonholder because the instrument is not payable to him or his order—that is, he fails the "words" requirement—and he does not transform himself into a holder, capable of indorsing, merely by altering the payee's name.⁴⁶

Therefore, in order to accomplish the drafters' intent in the *Wells Fargo* situation with the least violence to the Code, a court might choose to define "holder" as used in section 3-417 so as to include all bona fide purchasers for value. This would cause the same unpleasant result discussed above: it would leave "holder" meaning one thing for most purposes (that is, one who does *not* claim through the indorsement of a nonholder) and another thing for purposes of the exception in section 3-417 (that is, one who may claim through the indorsement of a nonholder). Yet this is surely preferable to the chaos which would follow from achieving the *Wells Fargo* result by retaining a single definition of "holder," thereby making the transferees of ordinary forgers into holders, and it has fewer undesirable side effects than the solution under section 3-413 which is described below.⁴⁷ The proper solution, no doubt, is to revise section 3-417 and add a definition of "indorse" to section 1-201.

45. The more favorable treatment given to transferees of altered checks cannot be justified on the grounds that they are less at fault than are the transferees of forged checks. If the forgery is done artfully (by forging the indorsement of the payee or last-named indorsee and making the check payable to the thief's own name) the transferee of the thief will not be able to discover the forgery by comparing the identification of the thief with that of the last-named indorsee. Moreover, given the facts that an altered check will always have been erased or changed in some way and that many checks are written by special means on special paper, the transferee of altered paper may ordinarily be more at fault in accepting the altered paper than is the transferee of forged paper in accepting forged paper.

46. See note 3 *supra*.

47. See text accompanying notes 54-55 *infra*.

II. GOOD TITLE

Section 3-417(1)(a) states that one presenting a negotiable instrument for payment warrants that he has "good title" to the instrument. There are two difficulties with the use of the words "good title" in that section: (1) it tends to obscure the treatment which the Code accords a holder in due course of a *bearer* instrument who traces his title to the instrument through a thief; and (2) it places an additional obstacle in the way of achieving the *Wells Fargo* outcome.

Under both the pre-NIL common law and the NIL, one who took a *bearer* instrument in good faith and for value from a thief had good title to the instrument.⁴⁸ Presumably the Code drafters intended to carry forward the same result.⁴⁹ However, "good title" is not defined in the Code and one ignorant of the eighteenth and nineteenth century case law development is likely to come to the opposite conclusion. In his ignorance of the specialized meaning of "good title" for Bills and Notes purposes, he may apply the standard personal property rule that one acquires only a "void title" from a thief.⁵⁰ By using words already freighted with a meaning which is contrary to that which they are intended to convey, the drafters have incorporated an unnecessary ambiguity in section 3-417(1)(a). Since the words can easily be replaced with more precise terms, the words should be changed.

Second, the attempt to obtain the *Wells Fargo* result under section 3-417 in the manner described above will be frustrated unless the "good title" requirement of that section is also reinterpreted. The presenter in *Wells Fargo* traced his title to an *order* instrument through one who had stolen the instrument, altered the payee's name,

48. The statement that the transferee had "good title" in this context means at least that he is not guilty of conversion by receiving payment on it and transferring it, and that he has a right to payment on the instrument which he can demand and enforce if necessary.

For cases holding that the taker of a bearer instrument from a thief has good title, see *Irwin v. Deming*, 142 Iowa 299, 120 N.W. 645 (1909); *Stricker v. Buncombe County*, 205 N.C. 536, 172 S.E. 188 (1934); *Texas Sporting Goods Co. v. Texas Gulf Sulphur Co.*, 81 S.W.2d 805 (Tex. Civ. App. 1935). These cases are some of the descendants of *Miller v. Race*, 1 Burr. 452, 97 Eng. Rep. 398 (K.B. 1758).

49. The presumed intention to carry forward the same result comes from the negative implication of comment 3 to § 3-417, which states that the purpose of the good title language is to deal with the forgery situation. The presumption is further supported by the absence of any language which suggests an intent to change the law. Such a fundamental change should not be assumed without an explicit statement in the Code or comments.

50. See U.C.C. § 2-403; BROWN, *LAW OF PERSONAL PROPERTY* § 67, at 231-32 (2d ed. 1955). Although § 2-403(1) expands the voidable title concept to new transactions which were not covered prior to the Code, it carries forward the basic rule that one acquires only void title from a thief. Unless a thief acquired possession by some variety of voluntary transfer he has only a void title under Article Two.

procured acceptance by the drawee, and thereafter transferred by purported indorsement to the presenter who took it in good faith and for value. Does such a presenter have "good title" under section 3-417(1)(a)? If not, he will be in breach of his warranty of title. Comment 3 to section 3-417 indicates that the section carries forward the NIL and common law rule that one who traces title to an *order* instrument through a standard forged indorsement lacks "good title."⁵¹ The *Wells Fargo* presenter traces through a thief who, not being content with a single forgery, first altered and then signed the payee's name; thus he lacks the true payee's indorsement. At least one court has expressly held,⁵² and other courts have implicitly held,⁵³ that one who claims an order instrument through a thief who has not just forged the payee's indorsement but who has first changed the payee's name and then indorsed the changed name *also* lacks good title. In the face of these cases and in the absence of any satisfactory policy reason for finding "good title" in the *Wells Fargo* transferee and no such title in the transferee of a mine-run forger, a court will have difficulty reaching the *Wells Fargo* outcome under section 3-417 (1)(a).

An inviting escape from this dilemma in section 3-417 is to read the acceptor bank's contract under sections 3-413(1) and 3-410(1) as a promise to pay *any* good faith purchaser who presents any draft which has been accepted in an altered form. This argument focuses upon the acceptor's agreement to "pay according to the tenor at the time of his engagement." At first reading this suggestion appears commendable for its total avoidance of section 3-417's ambiguous "holder" and "good title" language. Moreover, section 3-413 is a lineal descendant of the NIL language which was the basis for the *National City Bank* and *Wells Fargo* cases and therefore would seem to be the most likely vehicle in the Code for dealing with the *Wells Fargo* situation. However, the difficulty is that the drafters of the Code did not intend such an interpretation; rather they intended the performance of the drawee's acceptance contract under sections

51. Section 3-417, comment 3 states:

Subsection (1)(a) retains the generally accepted rule that the party who accepts or pays does not "admit" the genuineness of indorsements, and may recover from the person presenting the instrument when they turn out to be forged. The justification for the distinction between forgery of the signature of the drawer and forgery of an indorsement is that the drawee is in a position to verify the drawer's signature by comparison with one in his hands, but has ordinarily no opportunity to verify an indorsement.

52. *Manufacturers & Traders Trust Co. v. Bank of Louisiana*, 167 So. 2d 383 (La. App. 1964), *writ refused*, 247 La. 247, 170 So. 2d 508 (1965).

53. *Interstate Trust Co. v. United States Nat'l Bank*, 67 Colo. 6, 185 Pac. 260 (1919); *Farmers Bank v. Bank of Abbeville*, 29 Ga. App. 472, 116 S.E. 204 (1923); *Andrews v. Sibley*, 220 Mass. 10, 107 N.E. 395 (1914).

3-413 and 3-410(1) to be conditioned upon the presenter's faithful performance of his section 3-417 good title and non-alteration warranties. That is, the drafters contemplated that the acceptor would agree, in effect, to "pay according to the original tenor *but only* to one who does not breach the warranties of title and alteration." An example will illustrate the drafters' intent: If a holder in due course had taken a draft which had been altered prior to his taking, had it accepted, and later *himself* presented it to the drawee bank for payment, section 3-417 is carefully drawn to place the loss upon him and not upon the bank.⁵⁴ Apparently the drafters intended to place the loss on the presenter in such a case since there was no transfer of the instrument after acceptance and therefore there was no transferee who could be disappointed at the failure of the bank to comply with what appeared to be an agreement to pay the instrument in its altered form.⁵⁵ The drafters went to considerable length to carve this situation out of section 3-417. Yet if one were to argue successfully that sections 3-413 and 3-410 provide that the drawee has agreed to pay *irrespective* of the breach of the presenter's warranties under section 3-417, the liability would be placed upon the bank whether the bona fide purchaser who presents for payment took the instrument before or after acceptance, and the drafters' efforts to treat these cases differently would be frustrated. For that reason I conclude that the acceptor's contract was intended to be read like a buyer's duty to pay under a sales contract which has been conditioned upon the seller's satisfactory performance of his warranties. If that be true, sections 3-413 and 3-410 do not solve the problem, for the acceptor in a *Wells Fargo* situation need not perform his contract "to pay according to the tenor at the time of his acceptance" if the presenter of the draft has breached his section 3-417 title or alteration warranties.⁵⁶

54. For the exception to apply there must be a transfer after acceptance. The relevant language in § 3-417(c)(iii) is as follows: "if the holder in due course took the draft *after* the acceptance" (Emphasis added.)

55. Comment 5 to § 3-417 states the principle as follows:

Subparagraph (iii) accordingly provides that such language is not sufficient to impose on the holder in due course the warranty of no material alteration where the holder took the draft after the acceptance and *presumably in reliance upon it*. (Emphasis added.)

56. There are at least two other possible escapes from the § 3-417 dilemma. The first is to treat the accepting bank as though it had issued a cashier's check when it accepted the check in question. This amiable fiction would produce the *Wells Fargo* outcome since one would ignore any alterations or forgeries which had occurred prior to the acceptance. However, it would deviate from the intent of the drafters of the code, for it would not limit recovery to holders in due course who had taken after the acceptance. Also, it would permit recovery against the accepting bank when the bank had accepted forged but unaltered paper, for it would cut off the accepting bank's argument under § 3-417(1)(a).

The second solution involves § 3-413(3). That section provides that the acceptor

Here, as above, the ultimate solution lies in redrafting section 3-417. The best interim answer, however, is to bend the "good title" concept so as to include the *Wells Fargo* presenter.

III. RECOVERY AGAINST THE DRAWER AND PRIOR INDORSERS ON LOST OR STOLEN CHECKS

If an order check is stolen from the payee or indorsee, the Code gives the aggrieved owner a right to recover from the drawee bank if it pays the thief or his transferees.⁵⁷ The aggrieved owner will also have a right against the thief in conversion and he may have a right to recover from certain parties intervening between the thief and the drawee bank.⁵⁸ But thieves are notoriously unpromising defendants and the drawee bank may not be subject to the jurisdiction of the local courts or it may not have paid on the instrument and may

"admits as against all subsequent parties . . . the existence of the payee and his then capacity to indorse." If one reads "payee" to refer to the one who presents the check for acceptance and concludes that the admission of "capacity to indorse" estops the acceptor bank from raising the flaw in the payee's title (he claims through a thief's indorsement), he reaches the *Wells Fargo* result. Since the bank is estopped only as to "subsequent parties," it can still raise the alteration and bad title defense against the one who presented for acceptance. Thus this solution is superior to the immediately foregoing one, for it permits the bank to defeat the party who presented for acceptance but requires it to pay those who take the check after acceptance.

This solution too would go slightly beyond the drafters' goal, for it would estop the accepting bank in the forgery as well as the alteration case. However, the real difficulty with this solution is that it probably misconstrues the words "capacity to indorse." The comment indicates that this portion of § 3-413 was enacted with the intention of making "no change in substance from the revisions of the original act." Cases under the NIL used the "existence of the payee and his then capacity to indorse" language to estop the maker of a note from arguing that his payee's indorsement was *ultra vires* or that the payee was an infant or otherwise incompetent. See, e.g., *Iowa Fed'n of Women's Clubs v. Dilley*, 234 Iowa 417, 12 N.W.2d 815 (1944) (*ultra vires* transfer); *Ingle Sys. Co. v. Norris*, 132 Tenn. 472, 178 S.W. 1113 (1915) (maker estopped to deny corporation's existence). The phrase thus went to his legal capacity to make a contract, not to his status as a holder or nonholder. If the words have the same meaning in the Code as they had under the NIL, § 3-413(3) is inapplicable to the *Wells Fargo* case.

57. Section 3-419(1)(c).

58. For a discussion of the thief's liability, see note 6 *supra*.

Under the common law the owner had a cause of action against transferees who had possession of the check between the thief and the drawee bank. See, e.g., *Merchants' Bank v. National Capital Press, Inc.*, 53 App. D.C. 59, 288 Fed. 265 (1923); *United States Portland Cement Co. v. United States Nat'l Bank*, 61 Colo. 334, 157 Pac. 202 (1916); *Central Trust Co. v. Backsman*, 50 Ohio App. 512, 198 N.E. 730 (1935); *Henderson v. Lincoln Rochester Trust Co.*, 303 N.Y. 27, 100 N.E.2d 117 (1950). Section 3-419(3) removes this liability from one who is a "representative, including a depository or collecting bank," who deals with the check in good faith, and who does not retain any proceeds. Thus banks in the collecting chain will usually have no liability for dealing with a stolen check [*But see Ervin v. Dauphin Deposit Trust Co.*, 38 Pa. D. & C.2d 473 (1965)]; there is some doubt, however, as to whether "representative" includes merchants and others who simply cash a check over a forged indorsement or whether the term is limited to banks in the chain of payment.

thus be innocent of conversion. In such cases the aggrieved owner's interest will likely turn to the drawer and to any prior indorsers of the check. The two Code provisions directly relevant to these causes of action are sections 3-802 and 3-804.⁵⁹

At the outset, the aggrieved owner will find that section 3-802 prevents his suing on any underlying obligation which may have existed between him and the drawer or prior indorser. Section 3-802 provides that the giving of a personal check suspends the underlying obligation "pro tanto until the instrument is due or if it is payable on demand *until its presentment*." [Emphasis added.] Since the owner will not have possession of the check because it will have been stolen, he cannot "present" it⁶⁰ and therefore it will not be in his power to end by presentment section 3-802's suspension of the underlying obligation.

Section 3-804 appears to provide some relief in the payee or indorsee-owner's case. That section gives the owner a right to sue and recover on lost or stolen instruments against "any party liable" on the instrument.⁶¹ The question then becomes: Who are the "parties liable" on the stolen check? If the item were a note, clearly the maker of the note would be "liable" on his contract under section 3-413(1).⁶² Presumably the drafters intended that the drawer and prior indorsers were also "parties liable," but there is a difficulty here. The maker

59. Section 3-802 provides:

(1) Unless otherwise agreed where an instrument is taken for an underlying obligation

- (a) the obligation is pro tanto discharged if a bank is drawer, maker or acceptor of the instrument and there is no recourse on the instrument against the underlying obligor; and
- (b) in any other case the obligation is suspended pro tanto until the instrument is due or if it is payable on demand until its presentment. If the instrument is dishonored action may be maintained on either the instrument or the obligation; discharge of the underlying obligor on the instrument also discharges him on the obligation.

(2) The taking in good faith of a check which is not postdated does not of itself so extend the time on the original obligation as to discharge a surety.

Section 3-804 provides:

The owner of an instrument which is lost, whether by destruction, theft or otherwise, may maintain an action in his own name and recover from any party liable thereon upon due proof of his ownership, the facts which prevent his production of the instrument and its terms. The court may require security indemnifying the defendant against loss by reason of further claims on the instrument.

60. Section 3-504 states that presentment must be "by or on behalf of the holder." Since § 1-201(20) makes possession a requirement of the holder status, the demand by the owner of the instrument who is not in possession will not constitute presentment. Moreover, § 3-505 gives the party to whom presentment is made the right to have the instrument exhibited to him in order for an effective presentment to be accomplished.

61. See note 60 *supra*.

62. Section 3-413(1) provides: "The maker or acceptor engages that he will pay the instrument according to its tenor at the time of his engagement or as completed pursuant to Section 3-115 on incomplete instruments."

of a note is primarily liable, but the drawer and indorser of a check are only secondarily liable—that is, a maker's liability arises either at once (on a demand note) or with the passage of the due date (on a note with a stated maturity), whereas the drawer's and indorser's liability arises only *after* certain other conditions have been fulfilled. More specifically, sections 3-413(2) and 3-414⁶³ provide that the drawer and prior indorser are liable to pay only “upon dishonor of the draft and any necessary notice of dishonor or presentment.” Since dishonor does not occur until presentment has been made or excused, and since one cannot present unless he has possession of the instrument, the payee who cannot regain possession of the stolen instrument will not be able to fulfill the conditions precedent to making the drawer and indorsers of a check “liable.” Thus the drawer and prior indorsers are not within the class against whom the owner's cause of action in section 3-804 runs; they are not “parties liable thereon.”

A combination of the suspension of the underlying obligation pursuant to section 3-802 and a literal reading of section 3-804 would produce unfortunate and surely unintended results. It would mean, for example, that a seller who had made a perfectly conforming performance of his contractual obligations, and who had received but lost the buyer's check, could never recover from the buyer-drawer. If the buyer chose not to issue a second check, he would enjoy a windfall equal to the value of the seller's performance. Irrespective of any fault by the payee in losing the check, the drawer should be made to pay once for conforming goods or services. The most that the buyer can ask is to be suitably indemnified against the possibility of having to pay a second time to a holder in due course of the lost or stolen instrument.⁶⁴

63. Section 3-413(2) provides: “The drawer engages that upon dishonor of the draft and any necessary notice of dishonor or protest he will pay the amount of the draft to the holder or to any indorser who takes it up. The drawer may disclaim this liability by drawing without recourse.”

Section 3-414(1) provides:

Unless the indorsement otherwise specifies (as by such words as “without recourse”) every indorser engages that upon dishonor and any necessary notice of dishonor and protest he will pay the instrument according to its tenor at the time of his endorsement to the holder or to any subsequent indorser who takes it up, even though the indorser who takes it up was not obligated to do so.

64. If the stolen or lost instrument is a bearer instrument, it may get into the hands of a holder in due course. Under § 3-305 the drawer would be obliged to pay this holder in due course, despite the prior theft of the instrument. It is also possible that a transferee from a thief of an order instrument could assert rights against the drawer and cause him some expense in defending himself. In either event, it is appropriate to place this expense on the person from whom the instrument was stolen in order to encourage his future diligence in the safeguarding of checks and his early cashing of them.

Section 3-804 authorizes a court to require such indemnification, and a deviation in

A court can reach the appropriate result by several avenues under the present language of the Code. The first and most direct route is simply to read "liable" in section 3-804 so as to include secondary parties. This produces an inconsistency between section 3-804 (secondary parties "liable" without dishonor or notice) and the drawer's and indorser's contracts in sections 3-413 and 3-414 (secondary parties "liable" only with dishonor and notice). This approach also leaves open the questions whether one who sues the drawer or indorser on a lost or stolen check but cannot accomplish a true presentment must nevertheless make a presentment-like demand for payment from the bank and, if the bank refuses to pay, whether and when he must give notice of the bank's refusal.⁶⁵ It also raises the question whether an indorser or drawer whose liability has been discharged by the owner's delay in presentment prior to the loss or theft is to be treated as a person "liable thereon." Still, the proposed solution is simple, and a court can likely resolve the confusion about the need for and the necessary timing of the demand and notice.

A second, more subtle way to give the owner a right to sue on the lost or stolen check under section 3-804 is to excuse presentment in such situations. Section 3-511(2)(c) excuses presentment when "by reasonable diligence" one cannot accomplish it,⁶⁶ and, if presentment is so excused, section 3-507 states that the instrument is deemed dishonored without presentment if payment is not made.⁶⁷ This reading of sections 3-511 and 3-507 thus permits the payee or indorsee owner to fulfill the conditions precedent to making the drawer liable (dishonor and notice) despite the fact he does not have the instrument in his possession. There are, however, several difficulties with this approach. A minor problem is that the drafters probably did not intend the excuse provisions of section 3-511 to be so used. Section 3-511(2)(c) is apparently designed to excuse presentment when the

§ 3-804 in California and New York directs the court to require such indemnification in such cases. The rationale underlying such indemnification provisions is, of course, that the drawer ought to have to pay the check once, but not more than once.

65. Except where it is excused (under § 3-511), § 3-501 requires presentment before any secondary party is charged, and subsection (2) of § 3-501 requires notice of dishonor before any indorser is charged. Unless excused, each of these must be given within a reasonable time. In the case of an indorser, a reasonable time for presentment is "seven days after his indorsement" (§ 3-503(2)(b)), and reasonable time for notice is three business days "after dishonor or receipt of notice of dishonor." Failure of timely presentment or notice discharges the indorser, but it has less serious consequences with respect to the drawer, whom it discharges only in the case in which the drawee or payor bank becomes insolvent during the delay (§ 3-502(1)(b)).

66. Section 3-511(2)(c) provides in part: "[B]y reasonable diligence the presentment or protest cannot be made or the notice given."

67. Section 3-507(1)(b) states that an instrument is dishonored when "presentment is excused and the instrument is not duly accepted or paid."

presenter possesses the instrument but the payor is absent or insolvent, not when the owner lacks possession and the payor is present and solvent.⁶⁸ A more serious problem is that allowing suit by excusing presentment when it could not be made "by reasonable diligence" invites a court to deny the owner's recovery on the lost instrument when the check was lost or stolen as a result of his negligence. In such cases a court might find presentment not excused because of owner-plaintiff's lack of "reasonable diligence." As suggested above, the maximum penalty which the owner should pay for his negligence is that he be required to indemnify the drawer or indorser against the possibility of a second demand for payment, and therefore the presence or absence of the "reasonable diligence" of which section 3-511 speaks should not be of such crucial importance. The final objection to treating the owner under section 3-511 as though he has presented is that such treatment will not only permit suit on the stolen or lost instrument under section 3-804, but it will also resurrect the underlying obligation, since presentment, and therefore presumably excuse of presentment, revives the underlying obligation under section 3-802. Giving the payee a right to sue on the underlying obligation is objectionable only because it may lead a court to permit suit without appropriate indemnification. Section 3-802 contains no authorization for the court to require such indemnification, whereas section 3-804 permits it and, in two states,⁶⁹ requires it. Indeed, some courts might infer a legislative intent from the explicit directions in section 3-804 that indemnification be required only in suits on the lost instrument and not in those on the underlying obligation.

To prevent unjust enrichment of drawers and indorsers it is clear that the payees and indorsees from whom instruments are stolen should be able to recover from the drawer or prior indorsers. In providing for such recovery, the least ancillary difficulties are caused by reading the language "persons liable thereon" in section 3-804 so as to include drawers and indorsers. This reading allows the payee to recover on the "lost or stolen instrument" provision despite the fact that the drawer and indorser are not properly "liable" on the instru-

68. Nowhere do the Code or comments tell the specific reason for the excuse provision in § 3-511. However, that provision is a direct descendant of §§ 82, 112, & 159 of the NIL, which sections seem to have been designed to deal with cases like the following: *Clark v. O'Neal*, 231 Ala. 577, 165 So. 853 (1936) (bank failed); *Engle v. Shepherd*, 100 Okla. 200, 229 Pac. 208 (1924) (bank in the hands of state agent for winding up); *Spencer v. Burakiewicz*, 288 Mass. 83, 192 N.E. 616 (1934) (bank "closed"); *Sunlite Co., Mfgs. v. Justice*, 257 S.W. 579 (Tex. Civ. App. 1924) (corporation in receivership and such was known by indorser-defendants in present action). See also Llewellyn, *Supervening Impossibility of Performing Conditions Precedent in the Law of Negotiable Paper*, 23 COLUM. L. REV. 142, 154-55 (1923).

69. California and New York.

ment prior to presentment and dishonor. I would suggest that a permanent solution to the problem would be the addition of such a provision to section 3-804.

IV. PROPOSED REVISIONS

It would be ungracious, perhaps even cowardly, to criticize the design of Article Three without offering repairs and replacements for similar criticisms by others. The following revisions do not transform the Article Three machine into a Rolls Royce; they do, however, patch up the defects suggested above with the least interference with the present structure of the Code and with minimum unpleasant side-effects.

The "holder" ambiguities could be resolved as follows: Section 1-201 should read (new matter is italicized):

(20) "Holder" means a person who is in possession of a document of title or an instrument or an investment security drawn, *made* or indorsed to him or to his order or to bearer or in blank. *A person need not have acquired such possession by a voluntary transfer; a thief may be a holder.*

(47) "Indorsement." *Only a holder or a person acting on his behalf can "indorse" or make an "indorsement."*

Section 3-407(2)(a) should read as follows:

(a) alteration *which is both fraudulent and material by a holder who acquired possession by delivery* discharges any party whose contract is thereby changed unless that party assents or is precluded from asserting the defense;⁷⁰

Section 3-417 should be redrafted as follows in order to alleviate the ambiguities in the words "good title" and the difficulties raised by the *Wells Fargo* case:

70. Apparently the Code drafters were convinced that the sanction of discharge was necessary and desirable in order to inhibit alteration by holders. One can wonder whether the cure is not more painful than the illness, and can question whether the likelihood of a windfall under the present discharge rule is not greater than the likelihood of any salutary inhibition on a would-be alterer. Perhaps the rule should be changed to provide for no discharge even in the case of an alteration by a holder.

Professor Roy Steinheimer has suggested that § 3-407(2)(a) might be read to cause discharge only as to the claims of the one who made the alteration. See STEINHEIMER, MICHIGAN NEGOTIABLE INSTRUMENTS LAW AND THE UNIFORM COMMERCIAL CODE 92 (1960). This reading, which would substantially reduce the possibility of a windfall, is based upon the drafters' use of the article "the" to modify "holder" in lieu of "a." The difficulty with that reading is that it renders superfluous § 3-407(3) and the introductory phrase, "other than a subsequent holder in due course," of subsection (2). The proposed redraft substitutes the article "a" for "the."

Section 3-417. Warranties on Presentment and Transfer.

(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) *none of the indorsements on the instrument is forged or otherwise unauthorized; and*
- (b) *he did not steal or otherwise misappropriate the instrument or exceed his authority in presenting it; and*
- (c) *he has no knowledge that the signature of the maker or drawer 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*
- (d) *except for the knowledge of such thefts or misappropriations from which he is sheltered by an intervening transferee under the provisions of Section 3-201, he took the instrument without knowledge of any theft or misappropriation by persons through whom he traces his rights to the instrument; and*
- (e) *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 after the acceptance.*

*but, the warranties in subsections (a) and (e) are not given by a transferor who took the instrument for value and in good faith after acceptance to the acceptor of a draft with respect to any alteration or indorsement made prior to such acceptance, even though the acceptance provided "payable as originally drawn" or equivalent terms.*⁷¹

Language similar to that suggested as section 3-417(1)(a), (b), and (d) should be incorporated in section 3-417(2) to replace the good title statement. Revisions similar to those made in section 3-417 should also be made in section 4-207.

The following repairs should be made to section 3-804:

71. The revision of § 3-417 goes slightly beyond the *Wells Fargo* case for it would free a good faith taker of an accepted draft from liability not only in the alteration case, but also in the case in which there had been a forgery of the payee or an indorsee's name prior to acceptance. This seems a small extension of the bank's liability and one which is consonant with the policy expressed in comment 5 to § 3-417.

Section 3-804. Lost, Destroyed or Stolen Instruments.

(1) *Subject to subsections (2) and (3), the owner of an instrument which is lost, whether by destruction, theft or otherwise, may maintain an action in his own name and recover from any party liable thereon upon due proof of his ownership, the facts which prevent his production of the instrument and its terms. The court may require security indemnifying the defendant against loss by reason of further claims on the instrument.*

(2) *Any party who is ordinarily not liable without presentment, dishonor, protest, notice of protest, notice of dishonor, or a combination of the foregoing, shall nevertheless be deemed liable for the purposes of subsection (1) when the owner has:*

(a) *made a written demand for payment on the person to whom he would have presented the instrument for payment if he had possession of it; and*

(b) *such demand has been refused.*

(3) *Notwithstanding the owner's compliance with subsection (2), no party whose liability was discharged under Section 3-502 because of delay prior to theft or loss of the instrument shall be liable under subsection (1).*

V. CONCLUSION

The flaws here discussed fail the traditional test of significance, for they have produced no appellate cases; a skilled judge can likely operate the Article Three machine despite their presence. Moreover a systematic investigation of commercial practices might reveal that these ambiguities in fact have no significant impact upon those commercial practices. Yet it is troublesome that the important concept "holder" is not accurately defined, and it is disturbing to think that an uninformed court might hold that a forger's transferee was a holder in order to achieve the *Wells Fargo* result or that such a court might deny a deserved recovery to the owner of a lost check. Since these consequences can be avoided by a modest revision of a few sections, it is desirable that the repairs suggested above, or others like them, be made to the Article Three machinery.