Uniform Law Commission
NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS

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Articles 3 and 4 of the Uniform Commercial Code (2002)

-A Summary-

For over 100 years, the law of negotiable instruments has been governed by a uniform act. The initial Negotiable Instruments Law was promulgated by the ULC in 1896. It was the law of the land before the first decade of the 20th Century ended. It remained the law of the land until the Uniform Commercial Code was promulgated, initially in 1951. The old NIL was incorporated into Uniform Commercial Code (UCC), Articles 3 and 4. Article 3 is called "Negotiable Instruments" and is fundamental law to all negotiable instruments. Article 4 is entitled "Bank Deposits and Collections" but is more familiarly thought of as the law of checks. A check is a negotiable instrument drawn on a "bank." It is subject to the rules of Article 3, but Article 4 provides specific rules that apply to checks as negotiable instruments in the banking system.

Negotiable instruments always represent a right to payment of money, and are distinguishable from other documents that represent a right to payment by their ability to be freely transferred from person to person without regard for any obligations of any prior person who transferred the instrument. Transfer requires delivery of the paper instrument from one person to another. If there is a person listed as the payee on the instrument, free transfer (called negotiation) also requires an indorsement of the payee. If an instrument is made out to "bearer" negotiation occurs upon the delivery of the paper.

A person who takes a negotiable instrument by delivery and any necessary indorsement, becomes a holder of that instrument. If a holder has no knowledge of any obligations of any transferor of the instrument, that person is called a "holder-in-due-course." Holders-in-due-course may enforce the instrument and obtain payment without regard to any defenses against enforcement by any prior transferor. Free transferability of interests is the basic quality of negotiable instruments that distinguishes them from other paper with promises to pay money written on them.

Free transferability of the interests is what makes negotiable instruments so important. They are a fundamental and huge part of the payment system that sustains the economy. Without checks and bank accounts, and only cash, business could not be contracted safely and easily. Few areas of business could function without negotiable instruments. For example, promissory notes are fundamental to all real estate transactions. There would be no commercial paper market without negotiable instruments. They make economic activity possible by making credit-granting and payment possible.

Articles 3 and 4 were extensively revised and amended in 1990 and 1991. Article 3 was fully revised and Article 4 was updated by timely amendments. In 2002, these articles continue to provide efficient rules governing negotiable instruments and checks. But a decade of experience plus some changes in the transactional environment require some modest amendments:

1. To alleviate bad case law respecting bankruptcies, an amendment makes it clear that a person which has acquired ownership of an instrument directly or indirectly from a person entitled to enforce it when loss of possession occurred, may enforce the lost instrument. This solves a problem for the FDIC and others involved in transactions involving pooled instruments.

2. An amendment makes it clear that payment of an instrument to the person identified as the person with the power to enforce the instrument is discharged, even if the instrument has been transferred to another person who actually has the current power to enforce, until the person required to pay is notified of the transfer. Under current law, if a borrower's loan was transferred from one bank to another, and the borrower makes a payment to the first bank, the borrower may be obligated to make an identical payment to the second bank even though the first bank has received payment, if the second bank is a holder of the instrument in due course. Under the amendment to UCC §3-602, this situation would not arise. The second bank is deemed to have notice of the payment to the first bank if that payment was made before the borrower received adequate notification of the transfer of rights under the negotiable note.

3. A new phenomenon is telephonically generated checks, in which the consumer authorizes a check to be issued in his or her name over the telephone to pay an obligation. There are general warranties of transfer in both Articles 3 and 4 that facilitate the transfer of negotiable instruments and specifically checks. No existing warranty applies to these "remotely-generated consumer items (checks)." The warrantor is the customer or bank that transfers the check for settlement (payment). That person warrants that the "item" is authorized for the amount for which the item is drawn.

4. The rules of suretyship are updated to conform to the recent Restatement of Suretyship. A surety guarantees or assumes payment. Indorsers and "accommodation parties" are examples of sureties in negotiable instruments law. They assume obligations of payment by signing negotiable instruments that may be affected by discharge other than by payment to the persons who may enforce such instruments. The issue addressed in Articles 3 and 4 is what effect such a discharge has upon the obligations of the surety? When are those obligations discharged? Old Article 3 generally discharged the obligations of indorsers and accommodation parties to the extent that the drawer/maker of the instrument was discharged, while retaining any right of recourse for loss that the indorser or accommodation party might suffer against the drawer or maker of the instrument. O ld Article 3 also dealt with the effect of impairment of collateral associated with an instrument by the person entitled to enforce the interest. Generally, indorsers and accommodation parties were discharged from their secondary obligations to the extent of the impairment of collateral.

The amendments change the terminology to principal obligor and secondary obligor, consistent with the Restatement. When there is a discharge of primary obligor, the rights of a secondary obligor are more clearly and certainly provided for in the amendments. Any obligation of a primary obligor to a secondary obligor based on prior payment on the instrument remains unaffected. If recourse against the primary obligor is not reserved in a release by a party able to enforce the instrument, there is no recourse against the primary obligor after release. To the extent that a secondary obligor is not discharged when the primary obligor is discharged, the secondary obligor is discharged to the extent of any consideration given by the primary obligor and to the extent that the secondary obligor has a loss as a result of the primary obligor's discharge. Generally, extensions of time, specifically, to the primary obligor are extensions of time to the secondary obligor. If there is impairment of collateral, the secondary obligor has discharge to that extent, paralleling the old rule for indorsers and accommodation parties.

The conclusion from these changes is that scope is increased to the extent that secondary obligor is a broader term than indorser and accommodation party. Obligees and primary obligors have greater flexibility in reorganizing obligations, but cannot do so to the detriment of secondary obligors.

5. There are several requirements that certain documents be in writing. The amendments convert the term "writing" or "written" to "record," consistent with the Uniform Electronic Transactions Act. Electronic records, therefore, meet these statute of frauds requirements. However, the amendments do not authorize electronic negotiable instruments or checks.

6. The FTC has disclosure statement requirements that apply to instruments in consumer transactions. An amendment makes it clear that the omission of these required statements is not a defense against enforcement of an instrument under Article 3. An amendment also provides in Article 3 that applicable consumer law conflicting with Article 3 preempts conflicting Article 3 rules.

These rules contribute to the continued efficiency of transactions involving negotiable instruments and payment by checks. Every state needs to enact these amendments.

For further information about the UCC Articles 3 and 4, please contact ULC Chief Counsel Ben Orzeske at (312) 450-6600, or borzeske@uniformlaws.org.