

D R A F T

FOR APPROVAL

**AMENDMENTS TO
UNIFORM COMMERCIAL CODE ARTICLES 3 AND 4**

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

MEETING IN ITS ONE-HUNDRED-AND-ELEVENTH YEAR
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**AMENDMENTS TO
UNIFORM COMMERCIAL CODE ARTICLES 3 AND 4**

WITH PREFATORY NOTE AND PROPOSED COMMENTS

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By

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ON UNIFORM STATE LAWS

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AMENDMENTS TO UNIFORM COMMERCIAL CODE ARTICLES 3 AND 4

Prefatory Note

This project arose from a request sent from the Federal Reserve Board of New York to the Conference, related to provisions of Regulation CC (12 C.F.R. Part 229) that govern a variety of matters related to check collection. Based on that request, the ALI and NCCUSL initiated a project that was to have been brought before the ALI membership in May 2001 and before NCCUSL in the summer of 2001. As it turned out, there was not adequate support for the Regulation CC part of the project on the part of either the Federal Reserve or the banking industry. At the summer 2001 meeting, NCCUSL's Executive Committee approved a sharply truncated agenda for this project, designed to limit it to items where the need for reform is plain and the opportunity for justifiable controversy small.

The draft that is submitted includes only the items approved as part of that agenda. The amendments are limited to Articles 3 and 4 of the Uniform Commercial Code and include the following items:

1. Transferring Lost Instruments.—At least one case has held that the receiver of a failed bank cannot enforce an instrument transferred to it in the portfolio of a failed bank if the instrument was lost before the transfer. The result in that case poses a serious problem for the FDIC. A revision to UCC § 3-309 will call for a contrary result, making it clear that the party seeking to enforce a lost instrument need not have been in possession of the instrument at the time that it was lost.
2. Payment and Discharge.—Amendments to UCC §§ 3-602 conform that provision to the rules for payment that appear in the Restatement of Mortgages and in the Restatement of Contracts.
3. Telephonically Generated Checks.—Several States have adopted non-uniform amendments dealing with the responsibility for unauthorized telephone-generated checks. The draft includes warranties that generally place the responsibility for such checks on depositary banks rather than payor banks. The proposed items are limited to items that are drawn on a consumer account and do not bear a manual signature. The Drafting Committee considered extending those provisions to items drawn on a commercial account, but concluded that there was not sufficient consensus in the banking community about how such provisions should apply.
4. Suretyship.—Amendments to UCC §§ 3-419 and 3-605 generally conform those

provisions to the rules in the Restatement of Suretyship and Guaranty. There is some controversy about the revisions that appear in Section 3-605(a), which differ from the existing version of Section 3-605 by raising the possibility that a lender will discharge a guarantor if it grants a complete release to a borrower. The Drafting Committee concluded that the altered provisions are appropriate, however, because (as the Comments below explain) the rule of law in the Restatement is superior in that it is fairer to the guarantor. Moreover (again, as the Comments explain), the Drafting Committee does not believe that the alterations will apply to a broad range of transactions.

5. Electronic Communications.—Amendments to various provisions of Articles 3 and 4 implement the policy of the Uniform Electronic Transactions Act to remove unnecessary obstacles to electronic communications.

6. Consumer Notes.—A provision analogous to UCC § 9-404(d) indicates that a note for which the Federal Trade Commission requires a notice to be included will be treated as if the notice had been included. There is some opposition to that provision, but the Drafting Committee concluded that the provisions provide an appropriate implementation of the applicable federal regulations.

7. United Nations Convention on International Bills of Exchange and International Promissory Notes.—The draft includes several comments indicating similarities and differences between Article 3 and the United Nations Convention, designed to facilitate implementation of the Convention if the United States ratifies that convention in the coming years.

**AMENDMENTS TO
UNIFORM COMMERCIAL CODE ARTICLES 3 AND 4**

SECTION 3-102. SUBJECT MATTER.

Proposed Comments¹

Add the following to the end of Comment 5:

That Convention applies only to bills and notes that indicate on their face that they involve cross-border transactions. It does not apply at all to checks. Convention Articles 1(3), 2(1), 2(2). Moreover, because it applies only if the bill or note specifically calls for application of the Convention, Convention Article 1, there is little chance that the Convention will apply accidentally to a transaction that the parties intended to be governed by this Article.

SECTION 3-103. DEFINITIONS.

(a) In this Article:

(1) “Acceptor” means a drawee who has accepted a draft.

(2) “Consumer account” means an account established by an individual primarily for personal, family, or household purposes.

(3) “Consumer transaction” means a transaction in which an individual incurs an obligation primarily for personal, family, or household purposes.

(4) “Drawee” means a person ordered in a draft to make payment.

~~(3)~~(5) “Drawer” means a person who signs or is identified in a draft as a person ordering payment.

¹Proposed Comments for unamended sections require Permanent Editorial Board approval, and are shown here only for informational purposes in this draft. No action is required in this meeting.

1 ~~(4) “Good faith” means honesty in fact and the observance of reasonable commercial~~
2 ~~standards of fair dealing.~~ (6) **[Reserved]**

3 ~~(5)~~ (7) “Maker” means a person who signs or is identified in a note as a person
4 undertaking to pay.

5 ~~(6)~~ (8) “Order” means a written instruction to pay money signed by the person giving
6 the instruction. The instruction may be addressed to any person, including the person giving the
7 instruction, or to one or more persons jointly or in the alternative but not in succession. An
8 authorization to pay is not an order unless the person authorized to pay is also instructed to pay.

9 ~~(7)~~ (9) “Ordinary care” in the case of a person engaged in business means observance
10 of reasonable commercial standards, prevailing in the area in which the person is located, with
11 respect to the business in which the person is engaged. In the case of a bank that takes an
12 instrument for processing for collection or payment by automated means, reasonable commercial
13 standards do not require the bank to examine the instrument if the failure to examine does not
14 violate the bank’s prescribed procedures and the bank’s procedures do not vary unreasonably
15 from general banking usage not disapproved by this Article or Article 4.

16 ~~(8)~~ (10) “Party” means a party to an instrument.

17 (11) “Principal obligor,” with respect to an instrument, means the accommodated
18 party or any other party to the instrument against whom a secondary obligor has recourse under
19 this article.

20 ~~(9)~~ (12) “Promise” means a written undertaking to pay money signed by the person
21 undertaking to pay. An acknowledgment of an obligation by the obligor is not a promise unless

the obligor also undertakes to pay the obligation.

~~(10)~~ (13) “Prove” with respect to a fact means to meet the burden of establishing the fact (Section 1-201(8)).

~~(14)~~ **[Reserved]**

~~(11)~~ (15) “Remitter” means a person who purchases an instrument from its issuer if the instrument is payable to an identified person other than the purchaser.

(16) “Remotely-created consumer item” means an item drawn on a consumer account, which is not created by the payor bank and does not bear a handwritten signature purporting to be the signature of the drawer.

(17) “Secondary obligor,” with respect to an instrument, means (a) an indorser or an accommodation party, (b) a drawer having the obligation described in Section 3-414(d), or (c) any other party to the instrument that has recourse against another party to the instrument pursuant to Section 3-116(b).

(b) Other definitions applying to this Article and the sections in which they appear are:

“Acceptance”	Section 3-409
“Accommodated party”	Section 3-419
“Accommodation party”	Section 3-419
<u>“Account”</u>	<u>Section 4-104</u>
“Alteration”	Section 3-407
“Anomalous indorsement”	Section 3-205
“Blank indorsement”	Section 3-205
“Cashier’s check”	Section 3-104
“Certificate of deposit”	Section 3-104
“Certified check”	Section 3-409
“Check”	Section 3-104
“Consideration”	Section 3-303
“Draft”	Section 3-104
“Holder in due course”	Section 3-302

1	“Incomplete instrument”	Section 3-115
2	“Indorsement”	Section 3-204
3	“Indorser”	Section 3-204
4	“Instrument”	Section 3-104
5	“Issue”	Section 3-105
6	“Issuer”	Section 3-105
7	“Negotiable instrument”	Section 3-104
8	“Negotiation”	Section 3-201
9	“Note”	Section 3-104
10	“Payable at a definite time”	Section 3-108
11	“Payable on demand”	Section 3-108
12	“Payable to bearer”	Section 3-109
13	“Payable to order”	Section 3-109
14	“Payment”	Section 3-602
15	“Person entitled to enforce”	Section 3-301
16	“Presentment”	Section 3-501
17	“Reacquisition”	Section 3-207
18	“Special indorsement”	Section 3-205
19	“Teller’s check”	Section 3-104
20	“Transfer of instrument”	Section 3-203
21	“Traveler’s check”	Section 3-104
22	“Value”	Section 3-303

23 (c) The following definitions in other Articles apply to this Article:

24	“Bank”	Section 4-105
25	“Banking day”	Section 4-104
26	“Clearing house”	Section 4-104
27	“Collecting bank”	Section 4-105
28	“Depository bank”	Section 4-105
29	“Documentary draft”	Section 4-104
30	“Intermediary bank”	Section 4-105
31	“Item”	Section 4-104
32	“Payor bank”	Section 4-105
33	“Suspends payments”	Section 4-104

34 (d) In addition, Article 1 contains general definitions and principles of construction and
35 interpretation applicable throughout this Article.

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Comment 4 should be revised by replacing the first two sentences with the following: This Article now uses the standard definition of good faith in revised Article 1.

Comment 6 should be replaced with the following: The definition of consumer account includes a joint account established by more than one individual. See Section 1-106(1).

Proposed Comments

SECTION 3-106. UNCONDITIONAL PROMISE OR ORDER.

(b) A promise or order is not made conditional (i) by a reference to another writing record

1 for a statement of rights with respect to collateral, prepayment, or acceleration, or (ii) because
2 payment is limited to resort to a particular fund or source.

3 (c) If a promise or order requires, as a condition to payment, a countersignature by a
4 person whose specimen signature appears on the promise or order, the condition does not make
5 the promise or order conditional for the purposes of Section 3-104(a). If the person whose
6 specimen signature appears on an instrument fails to countersign the instrument, the failure to
7 countersign is a defense to the obligation of the issuer, but the failure does not prevent a
8 transferee of the instrument from becoming a holder of the instrument.

9 (d) If a promise or order at the time it is issued or first comes into possession of a holder
10 contains a statement, required by applicable statutory or administrative law, to the effect that the
11 rights of a holder or transferee are subject to claims or defenses that the issuer could assert
12 against the original payee, the promise or order is not thereby made conditional for the purposes
13 of Section 3-104(a); but if the promise or order is an instrument, there cannot be a holder in due
14 course of the instrument.

15
16 **SECTION 3-116. JOINT AND SEVERAL LIABILITY; CONTRIBUTION.**

17 (a) Except as otherwise provided in the instrument, two or more persons who have the
18 same liability on an instrument as makers, drawers, acceptors, indorsers who indorse as joint
19 payees, or anomalous indorsers are jointly and severally liable in the capacity in which they sign.

20 (b) Except as provided in Section 3-419(e) or by agreement of the affected parties, a

1 party having joint and several liability who pays the instrument is entitled to receive from any
2 party having the same joint and several liability contribution in accordance with applicable law.

3 ~~(c) Discharge of one party having joint and several liability by a person entitled to enforce~~
4 ~~the instrument does not affect the right under subsection (b) of a party having the same joint and~~
5 ~~several liability to receive contribution from the party discharged.~~

6 **Proposed Comments**

7 The last two sentences of comment 1 should be replaced by the following: Because one of the
8 joint and several obligors may have recourse against the other joint and several obligor under
9 subsection (b), each party that is jointly and severally liable under subsection (a) is a secondary
10 obligor in part and a principal obligor in part, as those terms are defined in Section 3-103(a).
11 Accordingly, Section 3-605 determines the effect of a release, an extension of time, or a
12 modification of the obligation of one of the joint and several obligors, as well as the effect of an
13 impairment of collateral provided by one of those obligors.

14 15 16 **SECTION 3-118. STATUTE OF LIMITATIONS.**

17 **Proposed Comments**

18 7. One of the most significant differences between this Article and the Convention on
19 International Bills of Exchange and International Promissory Notes is that the statute of
20 limitation under the Convention generally is only four years, rather than the six years provided by
21 this section. See Convention Article 84.

22 23 **SECTION 3-119. NOTICE OF RIGHT TO DEFEND ACTION.**

24 In an action for breach of an obligation for which a third person is answerable over pursuant
25 to this Article or Article 4, the defendant may give the third person ~~written~~ notice of the litigation
26 in a record, and the person notified may then give similar notice to any other person who is
27 answerable over. If the notice states (i) that the person notified may come in and defend and (ii)

1 that failure to do so will bind the person notified in an action later brought by the person giving
2 the notice as to any determination of fact common to the two litigations, the person notified is so
3 bound unless after seasonable receipt of the notice the person notified does come in and defend.
4

5 **SECTION 3-203. TRANSFER OF INSTRUMENT; RIGHTS ACQUIRED BY**
6 **TRANSFER.**

7 **Proposed Comments**

8 6. The rules for transferring instruments set out in this section are similar to the rules in
9 Article 13 of the Convention on International Bills of Exchange and International Promissory
10 Notes.
11

12 **SECTION 3-205. SPECIAL INDORSEMENT; BLANK INDORSEMENT;**
13 **ANOMALOUS INDORSEMENT.**

14 **Proposed Comments**

15 4. Articles 14 and 16 of the Convention on International Bills of Exchange and International
16 Promissory Notes includes similar rules for blank and special indorsements.
17

18 **SECTION 3-301. PERSON ENTITLED TO ENFORCE INSTRUMENT.**

19 **Proposed Comments**

20 The following should be added before the last sentence: For example, it should include a
21 remitter that has received an instrument from the issuer but has not yet transferred or negotiated
22 the instrument to another person.
23

24 **SECTION 3-302. HOLDER IN DUE COURSE.**

25 **Proposed Comments**

26 8. The status of holder in due course resembles the status of protected holder under Article

29 of the Convention on International Bills of Exchange and International Promissory Notes.
The requirements for being a protected holder under Article 29 generally track those of Section 3-302.

SECTION 3-303. VALUE AND CONSIDERATION.

Proposed Comments

6. The term “promise” in paragraph (a)(1) is used in its normal meaning, not in the specialized meaning given that term in Section 3-103(a)(12). See Section 1-201 (“Changes from Former Law”). No inference should be drawn from the decision to retain the word “promise” here despite its specialized definition in Section 3-103. Indeed, that is true even though “undertaking” is used instead of “promise” in clause (i) of paragraph 3-104(a)(3). See Section 3-104 comment 1 (explaining the use of the term “undertaking” in Section 3-104 to avoid use of the defined term “promise”).

SECTION 3-305. DEFENSES AND CLAIMS IN RECOUPMENT; CLAIMS IN CONSUMER TRANSACTIONS.

(a) Except as ~~stated in subsection (b)~~, otherwise provided in this section, the right to enforce the obligation of a party to pay an instrument is subject to the following:

(1) a defense of the obligor based on (i) infancy of the obligor to the extent it is a defense to a simple contract, (ii) duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor, (iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms, or (iv) discharge of the obligor in insolvency proceedings;

(2) a defense of the obligor stated in another section of this Article or a defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing a

1 right to payment under a simple contract; and

2 (3) a claim in recoupment of the obligor against the original payee of the instrument if
3 the claim arose from the transaction that gave rise to the instrument; but the claim of the obligor
4 may be asserted against a transferee of the instrument only to reduce the amount owing on the
5 instrument at the time the action is brought.

6 (b) The right of a holder in due course to enforce the obligation of a party to pay the
7 instrument is subject to defenses of the obligor stated in subsection (a)(1), but is not subject to
8 defenses of the obligor stated in subsection (a)(2) or claims in recoupment stated in subsection
9 (a)(3) against a person other than the holder.

10 (c) Except as stated in subsection (d), in an action to enforce the obligation of a party to
11 pay the instrument, the obligor may not assert against the person entitled to enforce the
12 instrument a defense, claim in recoupment, or claim to the instrument (Section 3-306) of another
13 person, but the other person's claim to the instrument may be asserted by the obligor if the other
14 person is joined in the action and personally asserts the claim against the person entitled to
15 enforce the instrument. An obligor is not obliged to pay the instrument if the person seeking
16 enforcement of the instrument does not have rights of a holder in due course and the obligor
17 proves that the instrument is a lost or stolen instrument.

18 (d) In an action to enforce the obligation of an accommodation party to pay an instrument,
19 the accommodation party may assert against the person entitled to enforce the instrument any
20 defense or claim in recoupment under subsection (a) that the accommodated party could assert

1 against the person entitled to enforce the instrument, except the defenses of discharge in
2 insolvency proceedings, infancy, and lack of legal capacity.

3 (e) In a consumer transaction, if law other than this article requires that an instrument
4 include a statement to the effect that the rights of a holder or transferee are subject to a claim or
5 defense that the issuer could assert against the original payee, and the instrument does not include
6 such a statement:

7 (1) the instrument has the same effect as if the instrument included such a statement;

8 (2) the issuer may assert against the holder or transferee all claims and defenses that
9 would have been available if the instrument included such a statement; and

10 (3) the extent to which claims may be asserted against the holder or transferee is
11 determined as if the instrument included such a statement.

12 (f) This section is subject to law other than this article that establishes a different rule for
13 consumer transactions.

14 **Proposed Comments**

15 6. Subsection (e) is added to clarify the treatment of an instrument that omits the notice
16 currently required by the Federal Trade Commission Rule related to consumer credit sales (16
17 C.F.R. Part 433). It reflects the reasoning of cases such as Associates Home Equity Services,
18 Inc. v. Troup, 778 A.2d 529, 540-43 (N.J. Super. Ct. 2001); and Gonzalez v. Old Kent Mortgage
19 Co., 2000 WL 1469313, at *5 (E.D. Pa. 2000). It is based on the language describing that rule in
20 Section 3-106(d) and the analogous provision in Section 9-404(d).

21 7. Subsection (f) is modeled on Sections 9-403(e) and 9-404(c). It ensures that Section 3-
22 305 is interpreted to accommodate relevant consumer-protection laws.

23 8. Articles 28 and 30 of the Convention on International Bills of Exchange and International
24 Promissory Notes includes a similar dichotomy, with a narrower group of defenses available

1 against a protected holder under Articles 28(1) and 30 than are available under Article 28(2)
2 against a holder that is not a protected holder.

4 **SECTION 3-306. CLAIMS TO AN INSTRUMENT.**

5 **Proposed Comments**

6 Add the following sentence at the end: The rule of this section is similar to the rule of Article
7 30(2) of the Convention on International Bills of Exchange and International Promissory Notes.

9 **SECTION 3-309. ENFORCEMENT OF LOST, DESTROYED, OR STOLEN** 10 **INSTRUMENT.**

11 (a) A person not in possession of an instrument is entitled to enforce the instrument if

12 (1) the person seeking to enforce the instrument

13 ~~(i) the person was in possession of the instrument and (A) was~~ entitled to enforce
14 ~~it~~ the instrument when loss of possession occurred, or

15 (B) has directly or indirectly acquired ownership of the instrument from a person
16 who was entitled to enforce the instrument when loss of possession occurred;

17 ~~(ii) (2)~~ the loss of possession was not the result of a transfer by the person or a
18 lawful seizure; and

19 ~~seizure, and (iii) (3)~~ the person cannot reasonably obtain possession of the instrument
20 because the instrument was destroyed, its whereabouts cannot be determined, or it is in the
21 wrongful possession of an unknown person or a person that cannot be found or is not amenable

1 to service of process.

2 (b) A person seeking enforcement of an instrument under subsection (a) must prove the
3 terms of the instrument and the person's right to enforce the instrument. If that proof is made,
4 Section 3-308 applies to the case as if the person seeking enforcement had produced the
5 instrument. The court may not enter judgment in favor of the person seeking enforcement unless
6 it finds that the person required to pay the instrument is adequately protected against loss that
7 might occur by reason of a claim by another person to enforce the instrument. Adequate
8 protection may be provided by any reasonable means.

9 **Proposed Comments**

10 [Change existing comment to comment 1.]

11 2. Subsection (a) is intended to reject the result in *Dennis Joslin Co. v. Robinson*
12 *Broadcasting Corp.*, 977 F. Supp. 491 (D.D.C. 1997). A transferee of a lost instrument need
13 prove only that its transferor was entitled to enforce, not that the transferee was in possession at
14 the time the instrument was lost. The protections of subsection (a) should also be available when
15 instruments are lost during transit, because whatever the precise status of ownership at the point
16 of loss, either the sender or the receiver ordinarily would have been entitled to enforce the
17 instrument during the course of transit. The revisions to subsection (a) are not intended to alter
18 in any way the rules that apply to the destruction of checks in connection with truncation or any
19 other expedited method of check collection or processing. See Section 3-604(a).

20 3. A security interest may attach to the right of a person not in possession of an instrument to
21 enforce the instrument. Although the secured party may not be the owner of the instrument, the
22 secured party may nevertheless be entitled to exercise its debtor's right to enforce the instrument
23 by resorting to its collection rights under the circumstances described in Section 9-607. This
24 section does not address whether the person required to pay the instrument owes any duty to a
25 secured party that is not itself the owner of the instrument.
26
27

1 **SECTION 3-310. EFFECT OF INSTRUMENT ON OBLIGATION FOR WHICH**
2 **TAKEN.**

3 **Proposed Comments**

4
5 The following should be added at the end of the first paragraph of comment 3: What that means
6 is that even though the suspension of the obligation may end upon dishonor under paragraph
7 (b)(1), the obligation is not revived in the circumstances described in paragraph (b)(4).
8
9

10 **SECTION 3-312. LOST, DESTROYED, OR STOLEN CASHIER'S CHECK,**
11 **TELLER'S CHECK, OR CERTIFIED CHECK.**

12 (a) In this section:

13 (1) "Check" means a cashier's check, teller's check, or certified check.

14 (2) "Claimant" means a person who claims the right to receive the amount of a
15 cashier's check, teller's check, or certified check that was lost, destroyed, or stolen.

16 (3) "Declaration of loss" means a ~~written~~ statement, made in a record under penalty of
17 perjury, to the effect that (i) the declarer lost possession of a check, (ii) the declarer is the drawer
18 or payee of the check, in the case of a certified check, or the remitter or payee of the check, in the
19 case of a cashier's check or teller's check, (iii) the loss of possession was not the result of a
20 transfer by the declarer or a lawful seizure, and (iv) the declarer cannot reasonably obtain
21 possession of the check because the check was destroyed, its whereabouts cannot be determined,
22 or it is in the wrongful possession of an unknown person or a person that cannot be found or is
23 not amenable to service of process.

24 (4) "Obligated bank" means the issuer of a cashier's check or teller's check or the
25 acceptor of a certified check.

26 (b) A claimant may assert a claim to the amount of a check by a communication to the

1 obligated bank describing the check with reasonable certainty and requesting payment of the
2 amount of the check, if (i) the claimant is the drawer or payee of a certified check or the remitter
3 or payee of a cashier's check or teller's check, (ii) the communication contains or is accompanied
4 by a declaration of loss of the claimant with respect to the check, (iii) the communication is
5 received at a time and in a manner affording the bank a reasonable time to act on it before the
6 check is paid, and (iv) the claimant provides reasonable identification if requested by the
7 obligated bank. Delivery of a declaration of loss is a warranty of the truth of the statements made
8 in the declaration. If a claim is asserted in compliance with this subsection, the following rules
9 apply:

10 (1) The claim becomes enforceable at the later of (i) the time the claim is asserted, or
11 (ii) the 90th day following the date of the check, in the case of a cashier's check or teller's check,
12 or the 90th day following the date of the acceptance, in the case of a certified check.

13 (2) Until the claim becomes enforceable, it has no legal effect and the obligated bank
14 may pay the check or, in the case of a teller's check, may permit the drawee to pay the check.
15 Payment to a person entitled to enforce the check discharges all liability of the obligated bank
16 with respect to the check.

17 (3) If the claim becomes enforceable before the check is presented for payment, the
18 obligated bank is not obliged to pay the check.

19 (4) When the claim becomes enforceable, the obligated bank becomes obliged to pay
20 the amount of the check to the claimant if payment of the check has not been made to a person
21 entitled to enforce the check. Subject to Section 4-302(a)(1), payment to the claimant discharges
22 all liability of the obligated bank with respect to the check.

1 (c) If the obligated bank pays the amount of a check to a claimant under subsection (b)(4)
2 and the check is presented for payment by a person having rights of a holder in due course, the
3 claimant is obliged to (i) refund the payment to the obligated bank if the check is paid, or (ii) pay
4 the amount of the check to the person having rights of a holder in due course if the check is
5 dishonored.

6 (d) If a claimant has the right to assert a claim under subsection (b) and is also a person
7 entitled to enforce a cashier's check, teller's check, or certified check which is lost, destroyed, or
8 stolen, the claimant may assert rights with respect to the check either under this section or
9 Section 3-309.

10
11 **SECTION 3-412. OBLIGATION OF ISSUER OF NOTE OR CASHIER'S CHECK.**

12
13 **Proposed Comments**

14
15 4. The rule of this section is similar to the rule of Article 39 of the Convention on
16 International Bills of Exchange and International Promissory Notes.

17
18
19 **SECTION 3-413. OBLIGATION OF ACCEPTOR.**

20
21 **Proposed Comments**

22
23 Add the following sentence at the end of the comment: The rule of this section is similar to
24 the rule of Articles 41 of the Convention on International Bills of Exchange and International
25 Promissory Notes. Articles 42 and 43 of the Convention include more detailed rules that in many
26 respects do not have parallels in this Article.

27
28
29 **SECTION 3-414. OBLIGATION OF DRAWER.**

30
31 **Proposed Comments**

32
33 7. The obligation of the drawer under this section is similar to the obligation of the drawer
34 under Article 38 of the Convention on International Bills of Exchange and International

1 Promissory Notes.

2
3
4 **SECTION 3-415. OBLIGATION OF INDORSER.**

5
6 **Proposed Comments**

7
8 6. The rule of this section is similar to the rule of Article 44 of the Convention on
9 International Bills of Exchange and International Promissory Notes.

10
11
12 **SECTION 3-416. TRANSFER WARRANTIES.**

13 (a) A person who transfers an instrument for consideration warrants to the transferee and,
14 if the transfer is by indorsement, to any subsequent transferee that:

- 15 (1) the warrantor is a person entitled to enforce the instrument;
- 16 (2) all signatures on the instrument are authentic and authorized;
- 17 (3) the instrument has not been altered;
- 18 (4) the instrument is not subject to a defense or claim in recoupment of any party
19 which can be asserted against the warrantor; ~~and~~
- 20 (5) the warrantor has no knowledge of any insolvency proceeding commenced with
21 respect to the maker or acceptor or, in the case of an unaccepted draft, the ~~drawer~~; drawer; and
- 22 (6) with respect to a remotely-created consumer item, that the person on whose
23 account the item is drawn authorized the issuance of the item in the amount for which the item is
24 drawn.

25 (b) A person to whom the warranties under subsection (a) are made and who took the
26 instrument in good faith may recover from the warrantor as damages for breach of warranty an
27 amount equal to the loss suffered as a result of the breach, but not more than the amount of the

1 instrument plus expenses and loss of interest incurred as a result of the breach.

2 (c) The warranties stated in subsection (a) cannot be disclaimed with respect to checks.

3 Unless notice of a claim for breach of warranty is given to the warrantor within 30 days after the
4 claimant has reason to know of the breach and the identity of the warrantor, the liability of the
5 warrantor under subsection (b) is discharged to the extent of any loss caused by the delay in
6 giving notice of the claim.

7 (d) A [cause of action] for breach of warranty under this section accrues when the
8 claimant has reason to know of the breach.

9 **Proposed Comments**

10 8. Subsection (a)(6) is based on a number of nonuniform amendments designed to address
11 concerns about certain kinds of check fraud. The provision implements a limited rejection of
12 Price v. Neal, 97 Eng. Rep. 871 (K.B. 1762), so that in certain circumstances (those involving
13 remotely-created consumer checks) the payor bank can use a warranty claim to absolve itself of
14 responsibility for honoring an unauthorized item. The provision rests on the premise that
15 monitoring by depository banks can control this type of fraud more effectively than any practices
16 readily available to payor banks. The provision expressly includes both the case in which the
17 consumer does not authorize the item at all and also the case in which the consumer authorizes
18 the item but in an amount different from the amount in which the item is drawn. Similar
19 provisions appear in Sections 3-417, 4-207, and 4-208.

20 The provision supplements applicable federal law, which requires telemarketers who submit
21 instruments for payment to obtain the customer's "express verifiable authorization," which may
22 be either in writing or tape recorded and must be made available upon request to the customer's
23 bank. Federal Trade Commission's Telemarketing Sales Rule, 16 C.F.R. § 310.3(a)(3),
24 implementing the Telemarketing and Consumer Fraud and Abuse Prevention Act, 15 U.S.C. §§
25 6101-6108. Some states also have consumer-protection laws governing authorization of
26 instruments in telemarketing transactions. *See, e.g.*, 9 Vt. Stat. Ann. § 2464.

27
28 9. Article 45 of the Convention on International Bills of Exchange and International
29 Promissory Notes includes similar warranties.

30 31 32 **SECTION 3-417. PRESENTMENT WARRANTIES.**

33 (a) If an unaccepted draft is presented to the drawee for payment or acceptance and the

drawee pays or accepts the draft, (i) the person obtaining payment or acceptance, at the time of presentment, and (ii) a previous transferor of the draft, at the time of transfer, warrant to the drawee making payment or accepting the draft in good faith that:—

(1) the warrantor is, or was, at the time the warrantor transferred the draft, a person entitled to enforce the draft or authorized to obtain payment or acceptance of the draft on behalf of a person entitled to enforce the draft;

(2) the draft has not been altered; ~~and~~

(3) the warrantor has no knowledge that the signature of the drawer of the draft is ~~unauthorized.~~ unauthorized; and

(4) with respect to any remotely-created consumer item, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.

(b) A drawee making payment may recover from any warrantor damages for breach of warranty equal to the amount paid by the drawee less the amount the drawee received or is entitled to receive from the drawer because of the payment. In addition, the drawee is entitled to compensation for expenses and loss of interest resulting from the breach. The right of the drawee to recover damages under this subsection is not affected by any failure of the drawee to exercise ordinary care in making payment. If the drawee accepts the draft, breach of warranty is a defense to the obligation of the acceptor. If the acceptor makes payment with respect to the draft, the acceptor is entitled to recover from any warrantor for breach of warranty the amounts stated in this subsection.

(c) If a drawee asserts a claim for breach of warranty under subsection (a) based on an

1 unauthorized indorsement of the draft or an alteration of the draft, the warrantor may defend by
2 proving that the indorsement is effective under Section 3–404 or 3–405 or the drawer is
3 precluded under Section 3–406 or 4–406 from asserting against the drawee the unauthorized
4 indorsement or alteration.

5 (d) If (i) a dishonored draft is presented for payment to the drawer or an indorser or (ii)
6 any other instrument is presented for payment to a party obliged to pay the instrument, and (iii)
7 payment is received, the following rules apply:

8 (1) The person obtaining payment and a prior transferor of the instrument warrant to
9 the person making payment in good faith that the warrantor is, or was, at the time the warrantor
10 transferred the instrument, a person entitled to enforce the instrument or authorized to obtain
11 payment on behalf of a person entitled to enforce the instrument.

12 (2) The person making payment may recover from any warrantor for breach of
13 warranty an amount equal to the amount paid plus expenses and loss of interest resulting from
14 the breach.

15 (e) The warranties stated in subsections (a) and (d) cannot be disclaimed with respect to
16 checks. Unless notice of a claim for breach of warranty is given to the warrantor within 30 days
17 after the claimant has reason to know of the breach and the identity of the warrantor, the liability
18 of the warrantor under subsection (b) or (d) is discharged to the extent of any loss caused by the
19 delay in giving notice of the claim.

20 (f) A [cause of action] for breach of warranty under this section accrues when the
21 claimant has reason to know of the breach.

22 **Proposed Comments**

1 9. For discussion of subsection (a)(4), see Comment 8 to Section 3-416.
2
3

4 **SECTION 3-419. INSTRUMENTS SIGNED FOR ACCOMMODATION.**

5 (a) If an instrument is issued for value given for the benefit of a party to the instrument
6 (“accommodated party”) and another party to the instrument (“accommodation party”) signs the
7 instrument for the purpose of incurring liability on the instrument without being a direct
8 beneficiary of the value given for the instrument, the instrument is signed by the accommodation
9 party “for accommodation.”

10 (b) An accommodation party may sign the instrument as maker, drawer, acceptor, or
11 indorser and, subject to subsection (d), is obliged to pay the instrument in the capacity in which
12 the accommodation party signs. The obligation of an accommodation party may be enforced
13 notwithstanding any statute of frauds and whether or not the accommodation party receives
14 consideration for the accommodation.

15 (c) A person signing an instrument is presumed to be an accommodation party and there
16 is notice that the instrument is signed for accommodation if the signature is an anomalous
17 indorsement or is accompanied by words indicating that the signer is acting as surety or guarantor
18 with respect to the obligation of another party to the instrument. Except as provided in Section
19 3-605, the obligation of an accommodation party to pay the instrument is not affected by the fact
20 that the person enforcing the obligation had notice when the instrument was taken by that person
21 that the accommodation party signed the instrument for accommodation.

22 (d) If the signature of a party to an instrument is accompanied by words indicating
23 unambiguously that the party is guaranteeing collection rather than payment of the obligation of

1 another party to the instrument, the signer is obliged to pay the amount due on the instrument to a
2 person entitled to enforce the instrument only if (i) execution of judgment against the other party
3 has been returned unsatisfied, (ii) the other party is insolvent or in an insolvency proceeding, (iii)
4 the other party cannot be served with process, or (iv) it is otherwise apparent that payment cannot
5 be obtained from the other party.

6 (e) If the signature of a party to an instrument is accompanied by words indicating that the
7 party guarantees payment or the signer signs the instrument as an accommodation party in some
8 other manner that does not unambiguously indicate an intention to guarantee collection rather
9 than payment, the signer is obliged to pay the amount due on the instrument to a person entitled
10 to enforce the instrument in the same circumstances as the accommodated party would be
11 obliged, without prior resort to the accommodated party by the person entitled to enforce the
12 instrument.

13 (f) An accommodation party who pays the instrument is entitled to reimbursement from
14 the accommodated party and is entitled to enforce the instrument against the accommodated
15 party. In proper circumstances, an accommodation party may obtain relief that requires the
16 accommodated party to perform its obligations on the instrument. An accommodated party ~~who~~
17 that pays the instrument has no right of recourse against, and is not entitled to contribution from,
18 an accommodation party.

20 SECTION 3-502. DISHONOR.

22 Proposed Comments

24 The following should replace the first paragraph of comment 4:

1 Subsection (b) applies to unaccepted drafts other than documentary drafts. Subsection (b)(1)
2 applies to checks. Except for checks presented for immediate payment over the counter, which
3 are covered by subsection (b)(2), dishonor occurs according to rules stated in Article 4. Those
4 rules contemplate four separate situations that warrant discussion. The first two situations arise
5 in the normal course of affairs, in which the drawee bank makes settlement for the amount of the
6 check to the presenting bank. In the first situation, the drawee bank under Section 4-301 recovers
7 this settlement if it returns the check by its midnight deadline (Section 4-104). In that case the
8 check is not paid and dishonor occurs under Section 3-502(b)(1). The second situation arises if
9 the drawee bank has made such a settlement and does not return the check or give notice of
10 dishonor or nonpayment within the midnight deadline. In that case, the settlement becomes final
11 payment of the check under Section 4-215. Thus, no dishonor occurs regardless of whether the
12 drawee bank retains the check indefinitely or for some reason returns the check after its midnight
13 deadline.

14
15 The third and fourth situations arise less commonly, in cases in which the drawee bank does
16 not settle for the check when it is received. Under Section 4-302 if the drawee bank is not also
17 the depositary bank and retains the check without settling for it beyond midnight of the day it is
18 presented for payment, the bank at that point becomes “accountable” for the amount of the check,
19 i.e., it is obliged to pay the amount of the check. If the drawee bank is also the depositary bank,
20 the bank becomes accountable for the amount of the check if the bank does not pay the check or
21 return it or send notice of dishonor by its midnight deadline. Hence, if the drawee bank is also
22 the depositary bank and does not either settle for the check when it is received (a settlement that
23 would ripen into final payment if the drawee bank failed to take action to recover the settlement
24 by its midnight deadline) or return the check or an appropriate notice by its midnight deadline,
25 the drawee bank will become accountable for the amount of the check under Section 4-302.
26 Thus, in all cases in which the drawee bank becomes accountable under Section 4-302, the check
27 has not been paid (either by a settlement that became unrecoverable or otherwise) and thus, under
28 Section 3-502(b)(1), the check is dishonored.

29
30 The fact that a bank that is accountable for the amount of the check under Section 4-302 is
31 obliged to pay the check under Section 3-502(b) does not mean that the check has been paid.
32 Indeed, because each of the paragraphs of Section 4-302(b) is limited by its terms to situations in
33 which a bank has not paid the item, a drawee bank will be accountable under Section 4-302 only
34 in situations in which it has not previously paid the check. Section 3-502(b)(1) reflects the view
35 that a person presenting a check is entitled to payment, not just the ability to hold the drawee
36 accountable under Section 4-302. If that payment is not made in a timely manner, the check is
37 dishonored.

38 39 40 **SECTION 3-602. PAYMENT.**

41 (a) Subject to subsection ~~(b)~~, (c), an instrument is paid to the extent payment is made~~(i)~~

1 by or on behalf of a party obliged to pay the instrument, and~~(ii)~~ to a person entitled to enforce the
2 instrument.

3 (b) Subject to subsection (e) a note is paid to the extent payment is made by or on behalf
4 of a party obliged to pay the note to a person that formerly was entitled to enforce the note only if
5 at the time of the payment the party obliged to pay has not received adequate notification that the
6 note has been transferred and that payment is to be made to the transferee. A notification is
7 adequate only if it is signed by the transferor or the transferee; reasonably identifies the
8 transferred note; and provides an address at which payments subsequently can be made. Upon
9 request, a transferee shall seasonably furnish reasonable proof that the note has been transferred.
10 Unless the transferee complies with the request, a payment to the person that formerly was
11 entitled to enforce the note is effective for purposes of subsection (c) even if the party obliged to
12 pay the note has received a notification under this paragraph.

13 (c) Subject to subsection (e), to the extent of ~~the payment~~, a payment under subsections
14 (a) and (b), the obligation of the party obliged to pay the instrument is discharged even though
15 payment is made with knowledge of a claim to the instrument under Section 3-306 by another
16 person.

17 (d) Subject to subsection (e), a transferee, or any party that has acquired rights in the
18 instrument directly or indirectly from a transferee, including any such party that has rights as a
19 holder in due course, is deemed to have notice of any payment that is made under subsection (b)
20 after the date that the note is transferred to the transferee but before the party obliged to pay the
21 note receives adequate notification of the transfer.

22 ~~(b)~~ (e) The obligation of a party to pay the instrument is not discharged under ~~subsection~~

~~(a)~~ subsections (a) through (d) if:

(1) a claim to the instrument under Section 3-306 is enforceable against the party receiving payment and (i) payment is made with knowledge by the payor that payment is prohibited by injunction or similar process of a court of competent jurisdiction, or (ii) in the case of an instrument other than a cashier's check, teller's check, or certified check, the party making payment accepted, from the person having a claim to the instrument, indemnity against loss resulting from refusal to pay the person entitled to enforce the instrument; or

(2) the person making payment knows that the instrument is a stolen instrument and pays a person it knows is in wrongful possession of the instrument.

(f) As used in this section, “signed,” with respect to a record that is not a writing, includes the attachment to or logical association with the record of an electronic symbol, sound, or process to or with the record with the present intent to adopt or accept the record.

Proposed Comments

[Change existing comment to comment 1.]

2. Subsection (a) covers payments made in a traditional manner, to the person entitled to enforce the instrument. Subsection (b) deals with the situation in which a person entitled to enforce the instrument transfers the instrument without giving notice to parties obligated to pay the instrument. If that happens and one of those parties subsequently makes a payment to the transferor, the payment is effective even though it is not made to the person entitled to enforce the instrument. Unlike the earlier version of Section 3-602, this rule is consistent with Section 9-406(a), Restatement of Mortgages § 5.5, and Restatement of Contracts § 338(1).

3. In determining the party to whom a payment is made for purposes of this section, courts should look to traditional rules of agency. Thus, if the original payee of a note transfers ownership of the note to a third party but continues to service the obligation, the law of agency might treat payments made to the original payee as payments made to the third party.

1 **SECTION 3-604. DISCHARGE BY CANCELLATION OR RENUNCIATION.**

2 (a) A person entitled to enforce an instrument, with or without consideration, may
3 discharge the obligation of a party to pay the instrument (i) by an intentional voluntary act, such
4 as surrender of the instrument to the party, destruction, mutilation, or cancellation of the
5 instrument, cancellation or striking out of the party's signature, or the addition of words to the
6 instrument indicating discharge, or (ii) by agreeing not to sue or otherwise renouncing rights
7 against the party by a signed ~~writing~~ record.

8 (b) Cancellation or striking out of an indorsement pursuant to subsection (a) does not
9 affect the status and rights of a party derived from the indorsement.

10 (c) As used in this section, "signed," with respect to a record that is not a writing,
11 includes the attachment to or logical association with the record of an electronic symbol, sound,
12 or process to or with the record with the present intent to adopt or accept the record.
13
14

15 **SECTION 3-605. DISCHARGE OF SECONDARY OBLIGORS. ~~DISCHARGE OF~~**
16 **~~INDORSERS AND ACCOMMODATION PARTIES.~~**

17 (a) If a person entitled to enforce an instrument releases the obligation of a principal
18 obligor in whole or in part, and another party to the instrument is a secondary obligor with
19 respect to the obligation of that principal obligor, the following rules apply:

20 (1) Any obligations of the principal obligor to the secondary obligor with respect to
21 any previous payment by the secondary obligor are not affected. Unless the terms of the release
22 preserve the secondary obligor's recourse, the principal obligor is discharged, to the extent of the
23 release, from any other duties to the secondary obligor under this article.

1 (2) Unless the terms of the release provide that the person entitled to enforce the
2 instrument retains the right to enforce the instrument against the secondary obligor, the secondary
3 obligor is discharged to the same extent as the principal obligor from any unperformed portion of
4 its obligation on the instrument. If the instrument is a check and the obligation of the secondary
5 obligor is based on an indorsement of the check, the secondary obligor is discharged without
6 regard to the language or circumstances of the discharge or other release.

7 (3) If the secondary obligor is not discharged under paragraph (2), the secondary
8 obligor is discharged to the extent of the value of the consideration for the release, and to the
9 extent that the release would otherwise cause the secondary obligor a loss.

10 (b) If a person entitled to enforce an instrument grants a principal obligor an extension of
11 the time at which one or more payments are due on the instrument and another party to the
12 instrument is a secondary obligor with respect to the obligation of that principal obligor, the
13 following rules apply:

14 (1) Any obligations of the principal obligor to the secondary obligor with respect to
15 any previous payment by the secondary obligor are not affected. Unless the terms of the
16 extension preserve the secondary obligor's recourse, the extension correspondingly extends the
17 time for performance of any other duties owed to the secondary obligor by the principal obligor
18 under this article.

19 (2) The secondary obligor is discharged to the extent that the extension would
20 otherwise cause the secondary obligor a loss.

21 (3) To the extent that the secondary obligor is not discharged under paragraph (2), the
22 secondary obligor may perform its obligations to a person entitled to enforce the instrument as if

1 the time for payment had not been extended or, unless the terms of the extension provide that the
2 person entitled to enforce the instrument retains the right to enforce the instrument against the
3 secondary obligor as if the time for payment had not been extended, treat the time for
4 performance of its obligations as having been extended correspondingly.

5 (c) If a person entitled to enforce an instrument agrees, with or without consideration, to a
6 modification of the obligation of a principal obligor other than a complete or partial release or an
7 extension of the due date and another party to the instrument is a secondary obligor with respect
8 to the obligation of that principal obligor, the following rules apply:

9 (1) Any obligations of the principal obligor to the secondary obligor with respect to
10 any previous payment by the secondary obligor are not affected. The modification
11 correspondingly modifies any other duties owed to the secondary obligor by the principal obligor
12 under this article.

13 (2) The secondary obligor is discharged from any unperformed portion of its
14 obligation to the extent that the modification would otherwise cause the secondary obligor a loss.

15 (3) To the extent that the secondary obligor is not discharged under paragraph (2), the
16 secondary obligor may satisfy its obligation on the instrument as if the modification had not
17 occurred, or treat its obligation on the instrument as having been modified correspondingly.

18 (d) If the obligation of a principal obligor is secured by an interest in collateral, another
19 party to the instrument is a secondary obligor with respect to that obligation, and a person
20 entitled to enforce the instrument impairs the value of the interest in collateral, the obligation of
21 the secondary obligor is discharged to the extent of the impairment. The value of an interest in
22 collateral is impaired to the extent the value of the interest is reduced to an amount less than the

1 amount of the recourse of the secondary obligor, or the reduction in value of the interest causes
2 an increase in the amount by which the amount of the recourse exceeds the value of the interest.
3 For purposes of this subsection, impairing the value of an interest in collateral includes failure to
4 obtain or maintain perfection or recordation of the interest in collateral, release of collateral
5 without substitution of collateral of equal value or equivalent reduction of the underlying
6 obligation, failure to perform a duty to preserve the value of collateral owed, under Article 9 or
7 other law, to a debtor or other person secondarily liable, and failure to comply with applicable
8 law in disposing of or otherwise enforcing the interest in collateral.

9 (e) A secondary obligor is not discharged under subsection (a)(3), (b), (c), or (d) unless
10 the person entitled to enforce the instrument knows that the person is a secondary obligor or has
11 notice under Section 3-419(c) that the instrument was signed for accommodation.

12 (f) A secondary obligor is not discharged under this section if the secondary obligor
13 consents to the event or conduct that is the basis of the discharge, or the instrument or a separate
14 agreement of the party provides for waiver of discharge under this section specifically or by
15 general language indicating that parties waive defenses based on suretyship or impairment of
16 collateral. Unless the circumstances indicate otherwise, consent by the principal obligor to an act
17 that would lead to a discharge under this section constitutes consent to that act by the secondary
18 obligor if the secondary obligor controls the principal obligor or deals with the person entitled to
19 enforce the instrument on behalf of the principal obligor.

20 (g) A release or extension preserves a secondary obligor's recourse if the terms of the
21 release or extension provide that the person entitled to enforce the instrument retains the right to
22 enforce the instrument against the secondary obligor, and the recourse of the secondary obligor

1 continues as though the release or extension had not been granted.

2 (h) Except as otherwise provided in subsection (i), a secondary obligor asserting
3 discharge under this section has the burden of persuasion both with respect to the occurrence of
4 the acts alleged to harm the secondary obligor and loss or prejudice caused by those acts.

5 (i) If the secondary obligor demonstrates prejudice caused by an impairment of its
6 recourse, and the circumstances of the case indicate that the amount of loss is not reasonably
7 susceptible of calculation or requires proof of facts that are not ascertainable, it is presumed that
8 the act impairing recourse caused a loss or impairment equal to the liability of the secondary
9 obligor on the instrument. In that event, the burden of persuasion as to any lesser amount of the
10 loss is on the person entitled to enforce the instrument.

11 ~~(a) In this section, the term "indorser" includes a drawer having the obligation described~~
12 ~~in Section 3-414(d).~~

13 ~~(b) Discharge, under Section 3-604, of the obligation of a party to pay an instrument does~~
14 ~~not discharge the obligation of an indorser or accommodation party having a right of recourse~~
15 ~~against the discharged party.~~

16 ~~(c) If a person entitled to enforce an instrument agrees, with or without consideration, to~~
17 ~~an extension of the due date of the obligation of a party to pay the instrument, the extension~~
18 ~~discharges an indorser or accommodation party having a right of recourse against the party whose~~
19 ~~obligation is extended to the extent the indorser or accommodation party proves that the~~
20 ~~extension caused loss to the indorser or accommodation party with respect to the right of~~
21 ~~recourse.~~

22 ~~(d) If a person entitled to enforce an instrument agrees, with or without consideration, to a~~

1 material modification of the obligation of a party other than an extension of the due date, the
2 modification discharges the obligation of an indorser or accommodation party having a right of
3 recourse against the person whose obligation is modified to the extent the modification causes
4 loss to the indorser or accommodation party with respect to the right of recourse. The loss
5 suffered by the indorser or accommodation party as a result of the modification is equal to the
6 amount of the right of recourse unless the person enforcing the instrument proves that no loss
7 was caused by the modification or that the loss caused by the modification was an amount less
8 than the amount of the right of recourse.

9 (e) If the obligation of a party to pay an instrument is secured by an interest in collateral
10 and a person entitled to enforce the instrument impairs the value of the interest in collateral, the
11 obligation of an indorser or accommodation party having a right of recourse against the obligor is
12 discharged to the extent of the impairment. The value of an interest in collateral is impaired to
13 the extent (i) the value of the interest is reduced to an amount less than the amount of the right of
14 recourse of the party asserting discharge, or (ii) the reduction in value of the interest causes an
15 increase in the amount by which the amount of the right of recourse exceeds the value of the
16 interest. The burden of proving impairment is on the party asserting discharge.

17 (f) If the obligation of a party is secured by an interest in collateral not provided by an
18 accommodation party and a person entitled to enforce the instrument impairs the value of the
19 interest in collateral, the obligation of any party who is jointly and severally liable with respect to
20 the secured obligation is discharged to the extent the impairment causes the party asserting
21 discharge to pay more than that party would have been obliged to pay, taking into account rights
22 of contribution, if impairment had not occurred. If the party asserting discharge is an

1 ~~accommodation party not entitled to discharge under subsection (e), the party is deemed to have a~~
2 ~~right to contribution based on joint and several liability rather than a right to reimbursement. The~~
3 ~~burden of proving impairment is on the party asserting discharge.~~

4 ~~(g) Under subsection (e) or (f), impairing value of an interest in collateral includes (i)~~
5 ~~failure to obtain or maintain perfection or recordation of the interest in collateral, (ii) release of~~
6 ~~collateral without substitution of collateral of equal value, (iii) failure to perform a duty to~~
7 ~~preserve the value of collateral owed, under Article 9 or other law, to a debtor or surety or other~~
8 ~~person secondarily liable, or (iv) failure to comply with applicable law in disposing of collateral.~~

9 ~~(h) An accommodation party is not discharged under subsection (c), (d), or (e) unless the~~
10 ~~person entitled to enforce the instrument knows of the accommodation or has notice under~~
11 ~~Section 3-419(c) that the instrument was signed for accommodation.~~

12 ~~(i) A party is not discharged under this section if (i) the party asserting discharge consents~~
13 ~~to the event or conduct that is the basis of the discharge, or (ii) the instrument or a separate~~
14 ~~agreement of the party provides for waiver of discharge under this section either specifically or~~
15 ~~by general language indicating that parties waive defenses based on suretyship or impairment of~~
16 ~~collateral.~~

17 **Proposed Comments**

18
19 The following should be substituted for the existing comments.

20
21 1. This section contains rules that are applicable when a secondary obligor (as defined in
22 Section 3-103(a)(17)) is a party to an instrument. These rules essentially parallel modern
23 interpretations of the law of suretyship and guaranty that apply when a secondary obligor is not a
24 party to an instrument. See generally *Restatement of the Law, Third, Suretyship and Guaranty*
25 (1996).

26
27 2. Like the law of suretyship and guaranty, Section 3-605 provides secondary obligors with

1 defenses that are not available to other parties to instruments. The general operation of Section
2 3–605, and its relationship to the law of suretyship and guaranty, can be illustrated by an
3 example. Bank agrees to lend \$10,000 to Borrower, but only if Backer also is liable for
4 repayment of the loan. The parties could consummate that transaction in three different ways.
5 First, if Borrower and Backer incurred those obligations with contracts not governed by this
6 Article, the general law of suretyship and guaranty would be applicable. Under modern
7 nomenclature, Bank is the “obligee,” Borrower is the “principal obligor,” and Backer is the
8 “secondary obligor.” See *Restatement of Suretyship and Guaranty* §1. Then assume that Bank
9 and Borrower agree to a modification of their rights and obligations after the note is signed. For
10 example, they might agree that Borrower may repay the loan at some date after the due date, or
11 that Borrower may discharge its repayment obligation by paying Bank \$3,000 rather than
12 \$10,000. Alternatively, suppose that Bank releases collateral that Borrower has given to secure
13 the loan. Under the law of suretyship and guaranty, the secondary obligor may be discharged
14 under certain circumstances if these modifications of the obligations between Bank (the obligee)
15 and Borrower (the principal obligor) are made without the consent of Backer (the secondary
16 obligor). The rights that the secondary obligor has to a discharge of its liability in such cases
17 commonly are referred to as suretyship defenses. The extent of the discharge depends upon the
18 particular circumstances. See *Restatement of Suretyship and Guaranty* §§ 37, 39–44.

19
20 A second possibility is that the parties might decide to use a negotiable instrument to
21 effectuate the loan. In that scenario, Borrower signs a note under which Borrower is obliged to
22 pay \$10,000 to the order of Bank on a due date stated in the note. Backer becomes liable for the
23 repayment obligation by signing the note as a co-maker or indorser. In either case the note is
24 signed for accommodation, Backer is an accommodation party, and Borrower is the
25 accommodated party. See Section 3–419 (describing the obligations of accommodation parties).
26 For purposes of Section 3–605, Backer is also a “secondary obligor” and Borrower is a “principal
27 obligor,” as those terms are defined in Section 3–103. Because Backer is a party to the
28 instrument, its rights to a discharge based on any modification of obligations between Bank and
29 Borrower are governed by Section 3–605 rather than by the general law of suretyship and
30 guaranty. Within Section 3–605, subsection (a) describes the consequences of a release of
31 Borrower, subsection (b) describes the consequences of an extension of time, and subsection (c)
32 describes the consequences of other modifications.

33
34 The third possibility is that Borrower would use an instrument governed by this Article to
35 evidence its repayment obligation, but Backer’s obligation would be created in some way other
36 than by becoming party to that instrument. In that case, Backer’s rights are determined by
37 suretyship and guaranty law rather than by this Article. See Comment 3 to Section 3–419.

38
39 Secondary liability also often arises in connection with a note in a transaction that does not
40 involve a secondary obligor at the time that the principal obligation is created, where there is
41 subsequently a transfer of the collateral that is given to secure the obligation of the principal
42 obligor to repay the note. That occurs under the rule that a transferee of real or personal property
43 that assumes the obligation of the transferor as maker of a note secured by the property becomes

1 by operation of law a principal obligor, with the transferor becoming a secondary obligor.
2 *Restatement of Suretyship and Guaranty* § 2(e); *Restatement of Mortgages* § 5.1. Article 3 does
3 not determine the effect of the release of the transferee in that case because the assuming
4 transferee is not a “party” to the instrument as defined in Section 3-103(a)(10). Section 3-605(a)
5 does not apply then because the holder has not discharged the obligation of a “principal obligor,”
6 a term defined in Section 3-103(a)(11). Thus, the resolution of that question is governed by the
7 law of suretyship. See *Restatement of Suretyship and Guaranty* § 39.
8

9 3. Section 3-605 is not however, limited to the conventional situation of the accommodation
10 party discussed in Comment 2. It also applies in four other situations. First, it applies to
11 indorsers of notes who are not accommodation parties. Unless an indorser signs without
12 recourse, the indorser’s liability under Section 3–415(a) is functionally similar to that of a
13 guarantor of payment. For example, if Bank in the hypothetical discussed in Comment 2
14 indorsed the note and transferred it to Second Bank, Bank is liable to Second Bank in the event
15 of dishonor of the note by Borrower. Section 3-415(a). Because of that secondary liability as
16 indorser, Bank qualifies as a “secondary obligor” under Section 3-103(a)(17) and has the same
17 rights under Section 3-605 as an accommodation party.
18

19 Second, a similar analysis applies to the drawer of a draft that is accepted by a party that is
20 not a bank. Under Section 3-414(d), that drawer has liability on the same terms as an indorser
21 under Section 3-415(a). Thus, the drawer in that case is a “secondary obligor” under Section 3-
22 103(a)(17) and has rights under Section 3-605 to that extent.
23

24 Third, a similar principle justifies application of Section 3-605 to persons who indorse a
25 check. Assume that Drawer draws a check to the order of Payee. Payee then indorses the check
26 and transfers it to Transferee. If Transferee presents the check and it is dishonored, Transferee
27 may recover from Drawer under Section 3-414 or Payee under Section 3-415. Because of that
28 secondary liability as an indorser, Payee is a secondary obligor under Section 3-103(a)(17).
29 Drawer is a “principal obligor” under Section 3-103(a)(11). As noted in Comment 4, below,
30 however, Section 3-605(a)(3) will discharge indorsers of checks in some cases in which other
31 secondary obligors will not be discharged by this section.
32

33 Fourth, this section also deals with the rights of co-makers of instruments, even when those
34 co-makers do not qualify as accommodation parties. The co-makers’ rights of contribution under
35 Section 3-116 make each co-maker a secondary obligor to the extent of that right of contribution.
36

37 4. Subsection (a) is based on *Restatement of Suretyship and Guaranty* § 39. It addresses the
38 effects of a release of the principal obligor by the person entitled to enforce the instrument.
39 Paragraph (a)(1) governs the effect of that release on the principal obligor’s duties to the
40 secondary obligor; paragraphs (a)(2) and (a)(3) govern the effect of that release on the secondary
41 obligor’s duties to the person entitled to enforce the instrument.
42

43 With respect to the duties of the principal obligor, the release of course cannot affect

1 obligations of the principal obligor with respect to payments that the secondary obligor already
2 has made. But with respect to future payments by the secondary obligor, paragraph (a)(1) (based
3 on *Restatement of Suretyship and Guaranty* § 39(a)) provides that the principal obligor is
4 discharged, to the extent of the release, from any other duties to the secondary obligor. That rule
5 is appropriate because otherwise the discharge granted to the principal obligor would be illusory:
6 it would have obtained a release from a person entitled to enforce that instrument, but it would be
7 directly liable for the same sum to the secondary obligor if the secondary obligor later complied
8 with its secondary obligation to pay the instrument. This discharge does not occur, though, if the
9 terms of the release effect a “preservation of recourse” as described in subsection (g). See
10 Comment 10, below.
11

12 The discharge under paragraph (a)(1) of the principal obligor’s duties to the secondary
13 obligor is broad, applying to all duties under this article. This includes not only the principal
14 obligor’s liability as a party to an instrument (as a maker, drawer or indorser under Sections 3-
15 412 through 3-415) but also obligations under Sections 3-116 and 3-419.
16

17 Paragraph (a)(2) is based closely on *Restatement of Suretyship and Guaranty* § 39(b). It
18 articulates a default rule that the release of a principal obligor also discharges the secondary
19 obligor, to the extent of the release granted to the principal obligor, from any unperformed
20 portion of its obligation on the instrument. The discharge of the secondary obligor under
21 paragraph (a)(2) is phrased more narrowly than the discharge of the principal obligor is phrased
22 under paragraph (a)(1) because, unlike principal obligors, the only obligations of secondary
23 obligors in Article 3 are “on the instrument” as makers or indorsers.
24

25 The parties can opt out of that rule by including a contrary statement in the terms of the
26 release. The provision does not contemplate that any “magic words” are necessary. Thus,
27 discharge of the secondary obligor under paragraph (a)(2) is avoided not only if the terms of the
28 release track the statutory language (e.g., the person entitled to enforce the instrument “retains the
29 right to enforce the instrument” against the secondary obligor), or if the terms of the release
30 effect a preservation of recourse under subsection (g), but also if the terms of the release include
31 a simple statement that the parties intend to “release the principal obligor but not the secondary
32 obligor” or that the person entitled to enforce the instrument “reserves its rights” against the
33 secondary obligor. At the same time, because paragraph (a)(2) refers to the “terms of the
34 release,” extrinsic circumstances cannot be used to establish that the parties intended the
35 secondary obligor to remain obligated. If a release of the principal obligor includes such a
36 provision, the secondary obligor is, nonetheless, discharged to the extent of the consideration that
37 is paid for the release; that consideration is treated as a payment in partial satisfaction of the
38 instrument.
39

40 Notwithstanding language in the release that prevents discharge of the secondary obligor
41 under paragraph (a)(2), paragraph (a)(3) discharges the secondary obligor from its obligation to a
42 person entitled to enforce the instrument to the extent that the release otherwise would cause the
43 secondary obligor a loss. The rationale for that provision is that a release of the principal obligor

1 changes the economic risk for which the secondary obligor contracted. This risk may be
2 increased in two ways. First, by releasing the principal obligor, the person entitled to enforce the
3 instrument has eliminated the likelihood of future payments by the principal obligor that would
4 lessen the obligation of the secondary obligor. Second, unless the release effects a preservation
5 of the secondary obligor's recourse, the release eliminates the secondary obligor's claims against
6 the principal obligor with respect to any future payment by the secondary obligor. The discharge
7 provided by this paragraph prevents that increased risk from causing the secondary obligor a loss.
8 Moreover, permitting releases to be negotiated between the principal obligor and the person
9 entitled to enforce the instrument without regard to the consequences to the secondary obligor
10 would create an undue risk of opportunistic behavior by the obligee and principal obligor. That
11 concern is lessened, and the discharge is not provided by paragraph (a)(3), if the secondary
12 obligor has consented to the release or is deemed to have consented to it under subsection (f)
13 (which presumes consent by a secondary obligor to actions taken by a principal obligor if the
14 secondary obligor controls the principal obligor or deals with the person entitled to enforce the
15 instrument on behalf of the principal obligor). See Comment 9, below.

16
17 Subsection (a) (and Restatement Section 39(b), the concepts of which it follows quite
18 closely) is designed to facilitate negotiated workouts between a creditor and a principal obligor,
19 so long as they are not at the expense of a secondary obligor who has not consented to the
20 arrangement (either specifically or by waiving its rights to discharge under this section). Thus,
21 for example, the provision facilitates an arrangement in which the principal obligor pays some
22 portion of a guaranteed obligation, the person entitled to enforce the instrument grants a release
23 to the principal obligor in exchange for that payment, and the person entitled to enforce the
24 instrument pursues the secondary obligor for the remainder of the obligation. Under paragraph
25 (a)(2), the person entitled to enforce the instrument may pursue the secondary obligor despite the
26 release of the principal obligor so long as the terms of the release provide for this result. Under
27 paragraph (a)(3), though, the secondary obligor will be protected against any loss it might suffer
28 by reason of that release (if the secondary obligor has not waived discharge under subsection (f)).

29 It should be noted that the obligee may be able to minimize the risk of such loss (and, thus, of
30 the secondary obligor's discharge) by giving the secondary obligor prompt notice of the release
31 even though such notice is not required.

32
33 The foregoing principles are illustrated by the following cases:

34
35 *Case 1.* D borrows \$1000 from C. The repayment obligation is evidenced by a note issued
36 by D, payable to the order of C. S is an accommodation indorser of the note. As the due date
37 of the note approaches, it becomes obvious that D cannot pay the full amount of the note and
38 may soon be facing bankruptcy. C, in order to collect as much as possible from D and lessen
39 the need to seek recovery from S, agrees to release D from its obligation under the note in
40 exchange for \$100 in cash. The agreement to release D is silent as to the effect of the release
41 on S. Pursuant to Section 3-605(a)(2), the release of D discharges S from its obligations to C
42 on the note.

1 Case 2. Same facts as Case 1, except that the terms of the release provide that C retains its
2 rights to enforce the instrument against S. D is discharged from its obligations to S pursuant
3 to Section 3-605(a)(1), but S is not discharged from its obligations to C pursuant to Section
4 3-605(a)(2). However, if S could have recovered from D any sum it paid to C (had D not
5 been discharged from its obligation to S), S has been harmed by the release and is discharged
6 pursuant to Section 3-605(a)(3) to the extent of that harm.
7

8 Case 3. Same facts as Case 1, except that the terms of the release provide that C retains its
9 rights to enforce the instrument against S and that S retains its recourse against D. Under
10 subsection (g), the release effects a preservation of recourse. Thus, S is not discharged from
11 its obligations to C pursuant to Section 3-605(a)(2) and D is not discharged from its
12 obligations to S pursuant to Section 3-605(a)(1). Because S's claims against D are preserved,
13 S will not suffer the kind of loss described in Case 2. If no other loss is suffered by S as a
14 result of the release, S is not discharged pursuant to this section.
15

16 Case 4. Same facts as Case 3, except that D had made arrangements to work at a second job
17 in order to earn the money to fulfill its obligations on the note. When C released D, however,
18 D canceled the plans for the second job. While S still retains its recourse against D, S may be
19 discharged from its obligation under the instrument to the extent that D's decision to forgo
20 the second job causes S a loss because forgoing the job renders D unable to fulfill its
21 obligations to S under Section 3-419.
22

23 Subsection (a) reflects a change from former Section 3-605(b), which provided categorically
24 that the release of a principal obligor by the person entitled to enforce the instrument did not
25 discharge a secondary obligor's obligation on the instrument and assumed that the release also
26 did not discharge the principal obligor's obligations to the secondary obligor under Section 3-
27 419. The rule under subsection (a) is much closer to the policy of the *Restatement of Suretyship*
28 *and Guaranty* than was former Section 3-605(b). The change, however, is likely to affect only a
29 narrow category of cases. First, as discussed above, Section 3-605 applies only to transactions in
30 which the payment obligation is represented by a negotiable instrument, and, within that set of
31 transactions, only to those transactions in which the secondary obligation is incurred by
32 indorsement or cosigning, not to transactions that involve a separate document of guaranty. See
33 Comment 2, above. Second, as provided in subsection (f), secondary obligors cannot obtain a
34 discharge under subsection (a) in any transaction in which they have consented to the challenged
35 conduct. Thus, subsection (a) will not apply to any transaction that includes a provision waiving
36 suretyship defenses (a provision that is almost universally included in commercial loan
37 documentation) or to any transaction in which the creditor obtains the consent of the secondary
38 obligor at the time of the release.
39

40 The principal way in which subsection (a) goes beyond the policy of *Restatement* § 39 is with
41 respect to the liability of indorsers of checks. Specifically, the last sentence of paragraph (a)(2)
42 provides that a release of a principal obligor grants a complete discharge to the indorser of a
43 check, without requiring the indorser to prove harm. In that particular context, it seems likely

1 that continuing responsibility for the indorser often would be so inconsistent with the
2 expectations of the parties as to create a windfall for the creditor and an unfair surprise for the
3 indorser. Thus, the statute implements a simple rule that grants a complete discharge. The
4 creditor, of course, can avoid that rule by contracting with the secondary obligor for a different
5 result at the time that the creditor grants the release to the principal obligor.
6

7 5. Subsection (b) is based on *Restatement of Suretyship and Guaranty* § 40 and relates to
8 extensions of the due date of the instrument. An extension of time to pay a note is often
9 beneficial to the secondary obligor because the additional time may enable the principal obligor
10 to obtain the funds to pay the instrument. In some cases, however, the extension may cause loss
11 to the secondary obligor, particularly if deterioration of the financial condition of the principal
12 obligor reduces the amount that the secondary obligor is able to recover on its right of recourse
13 when default occurs. For example, suppose that the instrument is an installment note and the
14 principal debtor is temporarily short of funds to pay a monthly installment. The payee agrees to
15 extend the due date of the installment for a month or two to allow the debtor to pay when funds
16 are available. Paragraph (b)(2) provides that an extension of time results in a discharge of the
17 secondary obligor, but only to the extent that the secondary obligor proves that the extension
18 caused loss. See subsection (h) (discussing the burden of proof under Section 3-605). Thus, if
19 the extension is for a long period, the secondary obligor might be able to prove that during the
20 period of extension the principal obligor became insolvent, reducing the value of the right of
21 recourse of the secondary obligor. In such a case, paragraph (b)(2) discharges the secondary
22 obligor to the extent of that harm. Although not required to notify the secondary obligor of the
23 extension, the payee can minimize the risk of loss by the secondary obligor by giving the
24 secondary obligor prompt notice of the extension; prompt notice can enhance the likelihood that
25 the secondary obligor's right of recourse can remain valuable, and thus can limit the likelihood
26 that the secondary obligor will suffer a loss because of the extension. See *Restatement of*
27 *Suretyship and Guaranty* Section 38 comment b.
28

29 If the secondary obligor is not discharged under paragraph (b)(2) (either because it would not
30 suffer a loss by reason of the extension or because it has waived its right to discharge pursuant to
31 subsection (f)), it is important to understand the effect of the extension on the rights and
32 obligations of the secondary obligor. Consider the following cases:
33

34 *Case # 5.* A borrows money from Lender and issues a note payable to the order of Lender
35 that is due on April 1, 2002. B signs the note for accommodation at the request of Lender. B
36 signed the note either as co-maker or as an anomalous indorser. In either case Lender
37 subsequently makes an agreement with A extending the due date of A's obligation to pay the
38 note to July 1, 2002. In either case B did not agree to the extension, and the extension did not
39 address Lender's rights against B. Under paragraph (b)(1), A's obligations to B under this
40 article are also extended to July 1, 2002. Under paragraph (b)(3), if B is not discharged, B
41 may treat its obligations to Lender as also extended, or may pay the instrument on the original
42 due date.
43

1 Case # 6. Same facts as Case # 5, except that the extension agreement includes a statement
2 that the Lender retains its right to enforce the note against B on its original terms. Under
3 paragraph (b)(3), B is liable on the original due date, but under paragraph (b)(1) A's
4 obligations to B under Section 3-419 are not due until July 1, 2002.

5
6 Case #7. Same facts as Case #5, except that the extension agreement includes a statement
7 that the Lender retains its right to enforce the note against B on its original terms and B
8 retains its recourse against A as though no extension had been granted. Under paragraph
9 (b)(3), B is liable on the original due date. Under paragraph (b)(1), A's obligations to B
10 under Section 3-419 are not extended.

11
12 Under section 3-605(b), the results in Case #5 and Case #7 are identical to the results that
13 follow from the law of suretyship and guaranty. See *Restatement of Suretyship and Guaranty* §
14 40. The situation in Case #6 is not specifically addressed in the Restatement, but the resolution
15 in this Section is consistent with the concepts of suretyship and guaranty law as reflected in the
16 Restatement.

17
18 As a practical matter, an extension of the due date will normally occur only when the
19 principal obligor is unable to pay on the due date. The interest of the secondary obligor normally
20 is to acquiesce in the willingness of the person entitled to enforce the instrument to wait for
21 payment from the principal obligor rather than to pay right away and rely on an action against the
22 principal obligor that may have little or no value. But in unusual cases the secondary obligor
23 may prefer to pay the holder on the original due date so as to avoid continuing accrual of interest.
24 In such cases, the secondary obligor may do so. See paragraph (b)(3). If the terms of the
25 extension provide that the person entitled to enforce the instrument retains its right to enforce the
26 instrument against the secondary obligor on the original due date, though, those terms are
27 effective and the secondary obligor may not delay payment until the extended due date. Unless
28 the extension agreement effects a preservation of recourse, however, the secondary obligor may
29 not proceed against the principal obligor under Section 3-419 until the extended due date. See
30 paragraph (b)(1). To the extent that delay causes loss to the secondary obligor it is discharged
31 under paragraph (b)(2).

32
33 Even in those cases in which a secondary obligor does not have a duty to pay the instrument
34 on the original due date, it always has the right to pay the instrument on that date, and perhaps
35 minimize its loss by doing so. The secondary obligor is not precluded, however, from asserting
36 its rights to discharge under Section 3-605(b)(2) if it does not exercise that option. The critical
37 issue is whether the extension caused the secondary obligor a loss by increasing the difference
38 between its cost of performing its obligation on the instrument and the amount recoverable from
39 the principal obligor under this Article. The decision by the secondary obligor not to exercise its
40 option to pay on the original due date may, under the circumstances, be a factor to be considered
41 in the determination of that issue, especially if the secondary obligor has been given prompt
42 notice of the extension (as discussed above).

1 6. Subsection (c) is based on *Restatement of Suretyship and Guaranty* § 41. It is a residual
2 provision, which applies to modifications of the obligation of the principal obligor that are not
3 covered by subsections (a) and (b). Under subsection (c), a modification of the obligation of the
4 principal obligor (other than a release covered by subsection (a) or an extension of the due date
5 covered by subsection (b)), will result in discharge of the secondary obligor to the extent the
6 modification causes loss to the secondary obligor.

7
8 The following is an illustration of the kind of case to which subsection (c) applies:

9
10 *Case # 8.* Corporation borrows money from Lender and issues a note payable to Lender. X
11 signs the note as an accommodation party for Corporation. The note refers to a loan
12 agreement under which the note was issued, which states various events of default that allow
13 Lender to accelerate the due date of the note. Among the events of default are breach of
14 covenants not to incur debt beyond specified limits and not to engage in any line of business
15 substantially different from that currently carried on by Corporation. Without consent of X,
16 Lender agrees to modify the covenants to allow Corporation to enter into a new line of
17 business that X considers to be risky, and to incur debt beyond the limits specified in the loan
18 agreement to finance the new venture. This modification discharges X to the extent that the
19 modification otherwise would cause X a loss.

20
21 7. Subsection (d) is based on *Restatement of Suretyship and Guaranty* § 42 and deals with
22 the discharge of secondary obligors by impairment of collateral. The last sentence of subsection
23 (d) states four common examples of what is meant by impairment. Because it uses the term
24 “includes,” the provision allows a court to find impairment in other cases as well. There is
25 extensive case law on impairment of collateral. The secondary obligor is discharged to the extent
26 that the secondary obligor proves that impairment was caused by a person entitled to enforce the
27 instrument. For example, assume that the payee of a secured note fails to perfect the security
28 interest. The collateral is owned by the principal obligor who subsequently files in bankruptcy.
29 As a result of the failure to perfect, the security interest is not enforceable in bankruptcy. If the
30 payee were to obtain payment from the secondary obligor, the secondary obligor would be
31 subrogated to the payee’s security interest in the collateral under Section 3-419 and general
32 principles of suretyship law. See *Restatement of Suretyship and Guaranty* § 28(1)(c). In this
33 situation, though, the value of the security interest is impaired completely because the security
34 interest is unenforceable. Thus, the secondary obligor is discharged from its obligation on the
35 note to the extent of that impairment. If the value of the collateral impaired is as much or more
36 than the amount of the note, and if there will be no recovery on the note as an unsecured claim,
37 there is a complete discharge. Subsection (d) applies whether the collateral is personalty or
38 realty, whenever the obligation in question is in the form of a negotiable instrument.

39
40 8. Subsection (e) is based on the former Section 3-605(h). The requirement of knowledge in
41 the first clause is consistent with Section 9-628. The requirement of notice in the second clause
42 is consistent with Section 3-419(c).

1 9. The importance of the suretyship defenses provided in Section 3-605 is greatly diminished
2 by the fact that the right to discharge can be waived as provided in subsection (f). The waiver
3 can be effectuated by a provision in the instrument or in a separate agreement. It is standard
4 practice to include such a waiver of suretyship defenses in notes prepared by financial institutions
5 or other commercial creditors. Thus, Section 3-605 will result in the discharge of an
6 accommodation party on a note only in the occasional case in which the note does not include
7 such a waiver clause and the person entitled to enforce the note nevertheless takes actions that
8 would give rise to a discharge under this section without obtaining the consent of the secondary
9 obligor.

10
11 Because subsection (f) by its terms applies only to a discharge “under this section,”
12 subsection (f) does not operate to waive a defense created by other law (such as the law
13 governing enforcement of security interests under Article 9) that cannot be waived under that
14 law. See, e.g., Section 9-602.

15
16 The last sentence of subsection (f) creates an inference of consent on the part of the
17 secondary obligor whenever the secondary obligor controls the principal obligor or deals with the
18 creditor on behalf of the principal obligor. That sentence is based on *Restatement of Suretyship*
19 *and Guaranty* § 48(2).

20
21 10. Subsection (g) explains the criteria for determining whether the terms of a release or
22 extension preserve the secondary obligor’s recourse, a concept of importance in the application
23 of subsections (a) and (b). First, the terms of the release or extension must provide that the
24 person entitled to enforce the instrument retains the right to enforce the instrument against the
25 secondary obligor. Second, the terms of the release or extension must provide that the recourse
26 of the secondary obligor against the principal obligor continues as though the release or extension
27 had not been granted. Those requirements are drawn from *Restatement of Suretyship and*
28 *Guaranty* § 38.

29
30 11. Subsections (h) and (i) articulate rules for the burden of persuasion under Section 3-605.
31 Those rules are based on *Restatement of Suretyship and Guaranty* § 49.

32
33
34 **SECTION 4-103. VARIATION BY AGREEMENT; MEASURE OF DAMAGES;**
35 **ACTION CONSTITUTING ORDINARY CARE.**

36 **Proposed Comments**
37

38 [In comment 4, the reference to 3-103(a)(4) should be to 1-201(b)(20).]
39
40

1 **SECTION 4-104. DEFINITIONS AND INDEX OF DEFINITIONS.**

2 (a) In this Article, unless the context otherwise requires:

3 (1) “Account” means any deposit or credit account with a bank, including a demand,
4 time, savings, passbook, share draft, or like account, other than an account evidenced by a
5 certificate of deposit;

6 (2) “Afternoon” means the period of a day between noon and midnight;

7 (3) “Banking day” means the part of a day on which a bank is open to the public for
8 carrying on substantially all of its banking functions;

9 (4) “Clearing house” means an association of banks or other payors regularly clearing
10 items;

11 (5) “Customer” means a person having an account with a bank or for whom a bank
12 has agreed to collect items, including a bank that maintains an account at another bank;

13 (6) “Documentary draft” means a draft to be presented for acceptance or payment if
14 specified documents, certificated securities (Section 8-102) or instructions for uncertificated
15 securities (Section 8-102), or other certificates, statements, or the like are to be received by the
16 drawee or other payor before acceptance or payment of the draft;

17 (7) “Draft” means a draft as defined in Section 3-104 or an item, other than an
18 instrument, that is an order;

19 (8) “Drawee” means a person ordered in a draft to make payment;

20 (9) “Item” means an instrument or a promise or order to pay money handled by a bank
21 for collection or payment. The term does not include a payment order governed by Article 4A or
22 a credit or debit card slip;

(10) “Midnight deadline” with respect to a bank is midnight on its next banking day following the banking day on which it receives the relevant item or notice or from which the time for taking action commences to run, whichever is later;

(11) “Settle” means to pay in cash, by clearing-house settlement, in a charge or credit or by remittance, or otherwise as agreed. A settlement may be either provisional or final;

(12) “Suspends payments” with respect to a bank means that it has been closed by order of the supervisory authorities, that a public officer has been appointed to take it over, or that it ceases or refuses to make payments in the ordinary course of business.

(b) Other definitions applying to this Article and the sections in which they appear are:

“Agreement for electronic presentment”	Section 4-110.
“Bank”	Section 4-105.
“Collecting bank”	Section 4-105.
“Depository bank”	Section 4-105.
“Intermediary bank”	Section 4-105.
“Payor bank”	Section 4-105.
“Presenting bank”	Section 4-105.
“Presentment notice”	Section 4-110.

(c) The following definitions in other Articles apply to this Article:

“Acceptance”	Section 3-409.
“Alteration”	Section 3-407.
“Cashier’s check”	Section 3-104.
“Certificate of deposit”	Section 3-104.
“Certified check”	Section 3-409.
“Check”	Section 3-104.
“Good faith”	Section 3-103.
“Holder in due course”	Section 3-302.
“Instrument”	Section 3-104.
“Notice of dishonor”	Section 3-503.
“Order”	Section 3-103.
“Ordinary care”	Section 3-103.
“Person entitled to enforce”	Section 3-301.
“Presentment”	Section 3-501.
“Promise”	Section 3-103.

1	“Prove”	Section 3-103.
2	“Record”	Section 3-103.
3	“Remotely-Created consumer item”	Section 3-103.
4	“Teller’s check”	Section 3-104.
5	“Unauthorized signature”	Section 3-403.

(d) In addition, Article 1 contains general definitions and principles of construction and interpretation applicable throughout this Article.

SECTION 4-207. TRANSFER WARRANTIES.

(a) A customer or collecting bank that transfers an item and receives a settlement or other consideration warrants to the transferee and to any subsequent collecting bank that:

- (1) the warrantor is a person entitled to enforce the item;
- (2) all signatures on the item are authentic and authorized;
- (3) the item has not been altered;
- (4) the item is not subject to a defense or claim in recoupment (Section 3–305(a)) of any party that can be asserted against the warrantor; ~~and~~
- (5) the warrantor has no knowledge of any insolvency proceeding commenced with respect to the maker or acceptor or, in the case of an unaccepted draft, the ~~drawer~~; drawer; ~~and~~
- (6) with respect to any remotely-created consumer item, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.

(b) If an item is dishonored, a customer or collecting bank transferring the item and receiving settlement or other consideration is obliged to pay the amount due on the item (i) according to the terms of the item at the time it was transferred, or (ii) if the transfer was of an

1 incomplete item, according to its terms when completed as stated in Sections 3–115 and 3–407.

2 The obligation of a transferor is owed to the transferee and to any subsequent collecting bank that
3 takes the item in good faith. A transferor cannot disclaim its obligation under this subsection by
4 an indorsement stating that it is made “without recourse” or otherwise disclaiming liability.

5 (c) A person to whom the warranties under subsection (a) are made and who took the
6 item in good faith may recover from the warrantor as damages for breach of warranty an amount
7 equal to the loss suffered as a result of the breach, but not more than the amount of the item plus
8 expenses and loss of interest incurred as a result of the breach.

9 (d) The warranties stated in subsection (a) cannot be disclaimed with respect to checks.
10 Unless notice of a claim for breach of warranty is given to the warrantor within 30 days after the
11 claimant has reason to know of the breach and the identity of the warrantor, the warrantor is
12 discharged to the extent of any loss caused by the delay in giving notice of the claim.

13 (e) A cause of action for breach of warranty under this section accrues when the claimant
14 has reason to know of the breach.

15 **Proposed Comments**

16 [Change existing comment to comment 1.]
17

18
19 2. For an explanation of subsection (a)(6), see comment 8 to Section 3-416.
20
21

22 **SECTION 4-208. PRESENTMENT WARRANTIES.**

23 (a) If an unaccepted draft is presented to the drawee for payment or acceptance and the
24 drawee pays or accepts the draft, (i) the person obtaining payment or acceptance, at the time of
25 presentment, and (ii) a previous transferor of the draft, at the time of transfer, warrant to the

drawee that pays or accepts the draft in good faith that:

(1) the warrantor is, or was, at the time the warrantor transferred the draft, a person entitled to enforce the draft or authorized to obtain payment or acceptance of the draft on behalf of a person entitled to enforce the draft;

(2) the draft has not been altered; and

(3) the warrantor has no knowledge that the signature of the purported drawer of the draft is ~~unauthorized.~~ unauthorized; and

(4) with respect to any remotely-created consumer item, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.

(b) A drawee making payment may recover from a warrantor damages for breach of warranty equal to the amount paid by the drawee less the amount the drawee received or is entitled to receive from the drawer because of the payment. In addition, the drawee is entitled to compensation for expenses and loss of interest resulting from the breach. The right of the drawee to recover damages under this subsection is not affected by any failure of the drawee to exercise ordinary care in making payment. If the drawee accepts the draft (i) breach of warranty is a defense to the obligation of the acceptor, and (ii) if the acceptor makes payment with respect to the draft, the acceptor is entitled to recover from a warrantor for breach of warranty the amounts stated in this subsection.

(c) If a drawee asserts a claim for breach of warranty under subsection (a) based on an unauthorized indorsement of the draft or an alteration of the draft, the warrantor may defend by proving that the indorsement is effective under Section 3–404 or 3–405 or the drawer is

precluded under Section 3–406 or 4–406 from asserting against the drawee the unauthorized indorsement or alteration.

(d) If (i) a dishonored draft is presented for payment to the drawer or an indorser or (ii) any other item is presented for payment to a party obliged to pay the item, and the item is paid, the person obtaining payment and a prior transferor of the item warrant to the person making payment in good faith that the warrantor is, or was, at the time the warrantor transferred the item, a person entitled to enforce the item or authorized to obtain payment on behalf of a person entitled to enforce the item. The person making payment may recover from any warrantor for breach of warranty an amount equal to the amount paid plus expenses and loss of interest resulting from the breach.

(e) The warranties stated in subsections (a) and (d) cannot be disclaimed with respect to checks. Unless notice of a claim for breach of warranty is given to the warrantor within 30 days after the claimant has reason to know of the breach and the identity of the warrantor, the warrantor is discharged to the extent of any loss caused by the delay in giving notice of the claim.

(f) A cause of action for breach of warranty under this section accrues when the claimant has reason to know of the breach.

Proposed Comments

[Change existing comment to comment 1.]

2. For an explanation of subsection (a)(4), see comment 8 to Section 3-416.

1 **SECTION 4-212. PRESENTMENT BY NOTICE OF ITEM NOT PAYABLE BY,**
2 **THROUGH, OR AT BANK; LIABILITY OF DRAWER OR INDORSER.**

3 (a) Unless otherwise instructed, a collecting bank may present an item not payable by,
4 through, or at a bank by sending to the party to accept or pay a ~~written~~ record providing notice
5 that the bank holds the item for acceptance or payment. The notice must be sent in time to be
6 received on or before the day when presentment is due and the bank must meet any requirement
7 of the party to accept or pay under Section 3-501 by the close of the bank's next banking day
8 after it knows of the requirement.

9 (b) If presentment is made by notice and payment, acceptance, or request for compliance
10 with a requirement under Section 3-501 is not received by the close of business on the day after
11 maturity or, in the case of demand items, by the close of business on the third banking day after
12 notice was sent, the presenting bank may treat the item as dishonored and charge any drawer or
13 indorser by sending it notice of the facts.

14
15 **SECTION 4-301. POSTING; RECOVERY OF PAYMENT BY RETURN OF ITEMS;**
16 **TIME OF DISHONOR; RETURN OF ITEMS BY PAYOR BANK.**

17 (a) If a payor bank settles for a demand item other than a documentary draft presented
18 otherwise than for immediate payment over the counter before midnight of the banking day of
19 receipt, the payor bank may revoke the settlement and recover the settlement if, before it has
20 made final payment and before its midnight deadline, it

21 ~~(1) returns the item;~~ (1) returns the item;

22 (2) returns an image of the item, if the party to which the return is made has entered

1 into an agreement to accept an image as a return of the item; and the image is returned in
2 accordance with that agreement; or

3 ~~(2) sends written~~ (3) sends a record providing notice of dishonor or nonpayment if the
4 item is unavailable for return.

5 (b) If a demand item is received by a payor bank for credit on its books, it may return the
6 item or send notice of dishonor and may revoke any credit given or recover the amount thereof
7 withdrawn by its customer, if it acts within the time limit and in the manner specified in
8 subsection (a).

9 (c) Unless previous notice of dishonor has been sent, an item is dishonored at the time
10 when for purposes of dishonor it is returned or notice sent in accordance with this section.

11 (d) An item is returned:

12 (1) as to an item presented through a clearing house, when it is delivered to the
13 presenting or last collecting bank or to the clearing house or is sent or delivered in accordance
14 with clearing-house rules; or

15 (2) in all other cases, when it is sent or delivered to the bank's customer or transferor
16 or pursuant to instructions.

17 **Proposed Comments**

18
19 8. Paragraph (a)(2) is designed to facilitate electronic check-processing by authorizing the
20 payor bank to return an image of the item instead of the actual item. It applies only when the
21 payor bank and the party to which the return has been made have agreed that the payor bank can
22 make such a return and when the return complies with the agreement. The purpose of the
23 paragraph is to prevent third parties (such as the depositor of the check) from contending that the
24 payor bank missed its midnight deadline because it failed to return the actual item in a timely
25 manner. If the payor bank missed its midnight deadline, payment would have become final under
26 Section 4-215 and the depository bank would have lost its right of chargeback under Section 4-
27 214. Of course, the depository bank might enter into an agreement with its depositor to resolve

1 that problem, but it is not clear that agreements by banks with their customers can resolve all
2 such issues. In any event, paragraph (a)(2) should eliminate the need for such agreements.
3

4 Nothing in paragraph (a)(2) authorizes the payor bank to destroy the check. If the check is
5 destroyed intentionally, the party obligated to pay the instrument may be discharged under
6 Section 3-604(a). If the instrument is destroyed inadvertently, any party trying to enforce the
7 check would be left to its rights under Section 3-309.
8
9

10 **SECTION 4-403. CUSTOMER'S RIGHT TO STOP PAYMENT; BURDEN OF**
11 **PROOF OF LOSS.**

12 (a) A customer or any person authorized to draw on the account if there is more than one
13 person may stop payment of any item drawn on the customer's account or close the account by an
14 order to the bank describing the item or account with reasonable certainty received at a time and
15 in a manner that affords the bank a reasonable opportunity to act on it before any action by the
16 bank with respect to the item described in Section 4-303. If the signature of more than one
17 person is required to draw on an account, any of these persons may stop payment or close the
18 account.

19 (b) A stop-payment order is effective for six months, but it lapses after 14 calendar days if
20 the original order was oral and was not confirmed in ~~writing~~ a record within that period. A stop-
21 payment order may be renewed for additional six-month periods by a ~~writing~~ record given to the
22 bank within a period during which the stop-payment order is effective.

23 (c) The burden of establishing the fact and amount of loss resulting from the payment of
24 an item contrary to a stop-payment order or order to close an account is on the customer. The
25 loss from payment of an item contrary to a stop-payment order may include damages for dishonor
26 of subsequent items under Section 4-402.

1
2
3 **SECTION 4-406. CUSTOMER’S DUTY TO DISCOVER AND REPORT**
4 **UNAUTHORIZED SIGNATURE OR ALTERATION.**

5 **Proposed Comments**

6 [In comment 4, the reference to 3-103(a)(4) should be to 1-201(b)(20).]