MEMORANDUM

TO: 3-4-4A DRAFTING COMMITTEE

FROM: RONALD J. MANN AND EDWIN SMITH

SUBJECT: SUMMARY OF PROJECT

DATE: MARCH 30, 2000

This memorandum summarizes the various matters committed to the Committee's consideration. We hope that this memorandum can form the basis of discussion at the Committee's April meeting. Our goals for that meeting are (I) to determine as specifically as we can the precise topics that our revisions will address; (II) to identify any significant policy questions those revisions address so that we can analyze them for discussion at later meetings; and (III) to identify any topics on which input from affected industries or other ALI/NCCUSL committees would be useful. On those topics that we wish to address that do not seem to raise significant policy questions or require further input, the Reporter will prepare draft statutory language for consideration at the next meeting of the Committee.

The memorandum discusses the following topics:

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I. REGULATION CC

The current state of the law regarding check collection is complicated by the division of the relevant rules between UCC Article 4 and Regulation CC (10 CFR Part 229) promulgated by the Board of Governors of the Federal Reserve. The most significant motivation for the decision to undertake this project is the possibility that the portions of the check-collection rules that currently appear in subpart C of Regulation CC (that is, the collection rules, but not the funds-availability rules) could be repatriated to UCC Article 4. Because the project is more one to relocate legal rules than to change them, and because the Federal Reserve is firmly supporting the project, the prospects for success seem relatively high.

Because the general plan is to incorporate subpart C of Regulation CC as it stands, the number of significant policy questions is relatively small for a topic of this importance. It does, however, involve considerable drafting complexity and judgment in determining precisely which rules to incorporate into the UCC and precisely how to do it. The following paragraphs address the principal subjects raised in the relevant portions of Regulation CC (12 CFR §§ 229.30-229.43) that differ substantially from analogous portions of the UCC. This is not intended to be a comprehensive summary, only a summary of the provisions that seem likely to require significant work or cause significant difficulty.

A. PROCEDURAL REQUIREMENTS FOR DISHONOR

Regulation CC: One of the most important topics in Regulation CC is how a bank should react when it wishes to dishonor a check. If the bank on which the check is written (the "paying bank" in the regulatory terminology, see § 229.2(z)) wishes to dishonor the check and avoid any liability for it, the bank must comply with two separate requirements.

The Return Requirement: First, under § 229.30, the bank must return the check in an "expeditious" manner. Section 229.30 sets forward a byzantine definition of what counts as expeditious. Generally, a return is expeditious if it satisfies *either* the two-day/four-day test *or* the forward collection test.

The two-day/four-day test requires the bank to return a local check so that the depositary bank receives it on the second business bay after the paying bank received the check. § 229.30(a)(1)(i). The regulation grants a longer period, until the fourth business day, for nonlocal checks. § 229.30(a)(1)(ii). {The status of a check as local or non-local depends on whether the paying bank is located in the same check processing region as the depositary bank. The "[c]heck processing region" is the area served by an office of a Federal Reserve Bank. *See* §§ 229.2(m) (defining "Check processing region"), (r) (defining "Local check") & (v) (defining "Nonlocal check").}

The forward collection test requires the bank to return the check in the same way that a bank in the position of the paying bank normally would forward a check drawn on the depositary bank deposited with the paying bank on the same day.

Section 229.31 imposes similar obligations on a returning bank, that is, on any bank processing the return of the check that is not the paying bank. *See* § 229.2(cc) (defining "Returning bank").

The Notice Requirement: If a paying bank decides not to honor a check for $2,500 or more, it must provide notice of nonpayment to the depositary bank by the second business day after the paying bank received the check. § 229.33.

Article 4: Under Article 4, a bank that wishes to dishonor a check need not send any notice. Rather, it need only return the item by its midnight deadline (midnight at the conclusion of the banking day after the banking day on which it receives the item). §§ 4-104(a)(10) (defining midnight deadline), 4-301(a) (defining return requirement). In another twist, Regulation CC (separately from the creation of its own return requirement discussed above) has amended the UCC's midnight-deadline return requirement to permit certain highly expeditious methods of return, even if the paying bank waits to send the item until after the UCC midnight deadline. § 229.30(c).

Differences: The Article 4 and Regulation CC provisions differ in quite a number of ways. The most significant probably are:

- The additional notice requirement under Regulation CC

- The substantive difference between the midnight deadline, on the one hand, and the two-day/four-day – forward-collection test, on the other hand.

- The functional difference between the UCC deadline (which focuses on the time when an item is sent, see §§ 1-201(38), 4-301(d)(2)) and the Regulation CC deadlines (which focus on the time when the item is received).

- Regulation CC's concept of a direct return from the paying bank to the depositary bank rather than the Article 4 concept of a return from each bank to the collecting bank from which it received the item. Regulation CC also includes several related provisions (not summarized in this memorandum) that specify rules for where items are to be presented and returned; those rules are not precisely consistent with either the UCC's indirect return rules or the UCC's provision on the place for presentment, UCC § 4-204(c).

- A number of definitional quirks

    - Article 4 refers only to the "Banking day," while Regulation CC's deadlines refer to distinct concepts of the "Banking day" (§ 229.2(f)) and the "Business day" (§ 229.2(g)).

    - Regulation CC uses deadlines that depend in part on the Federal Reserve's internal organization {*see* § 229.2(m) (defining "Check processing region”)}; because that organization is likely to change from time to time, it is not clear how to incorporate those deadlines into state law. Section 4-213(a) might provide a useful model.

- Regulation CC distinguishes between the paying bank and the returning bank and the depositary bank, where Article 4 uses somewhat different categories of the payor bank, depositary bank, and collecting banks.

Implementation: The most promising way to incorporate those provisions of Regulation CC into Article 4 would be to revise and greatly expand § 4-301. Given the great detail of Regulation CC, a revision that left all of that material in a single section would create an extraordinarily long provision, perhaps longer than any section in the existing UCC. Accordingly, it seems almost inevitable that the material would be placed into several sections, requiring a complete recasting of at least Part 3 of Article 4.

The most obvious policy question is whether to retain the UCC’s midnight deadline or instead to move entirely to the federal system for motivating expeditious processing. On the one hand, eliminating the UCC requirement could be seen as a “pro-bank” move that makes it easier for banks to wait longer to dishonor. On the other hand, it is not clear as a practical matter that the midnight deadline provides any significant motivation beyond the Regulation CC rules in any significant number of cases. If it does not, it might be useful to simplify the rules by eliminating the duplicative return requirement that it imposes.

B. PROVISIONAL SETTLEMENTS

Regulation CC requires banks to settle for all checks on the date that it receives them, § 229.36(f), and treats all settlements during the course of collection as final. *See* § 229.36(d). It implements the return of funds for bounced checks by a separate obligation on the part of the depositary bank to pay the returning or paying bank, as applicable. § 229.32(b).

Article 4, in contrast, in a variety of places uses the concept of a provisional settlement or a settlement that can be revoked. *See* §§ 4-214(a), 4-215, 4-301(a). The general idea is that a bank makes a provisional settlement for the item and then recovers the funds by revoking that settlement if the check does not clear.

The differing conceptions of settlement plainly present the most confusing aspect of the current system, an area most in need of reform. Again, although it might require some extensive redrafting of Article 4, incorporation of the Regulation CC standards does not seem to present any significant policy issues, because banks already are operating under the Regulation CC rules.

C. EFFECT OF FAILED DISHONOR

The remedy provisions of Regulation CC are somewhat puzzling. It does not, strictly speaking, impose damages for the failure to comply with the notice and return requirements. Rather, it obligates a bank to use ordinary care and act in good faith in complying; if the bank fails to exercise ordinary care, it is responsible to the depositary bank, the customer, and other parties for the amount of the loss incurred, up to the amount of the check, reduced by the amount of the loss that would have ensued even if the bank had exercised ordinary care. If the bank failed to act in good faith, it also is liable for other damages that follow proximately from the bank's conduct. § 229.38(a). The plain implication is that a bank has no liability if it exercises ordinary care but still fails to comply with the notice and return requirements.

Article 4 differs in two significant respects. First, it does not treat a failed dishonor as an occasion for damages; rather it treats a failed dishonor as ineffective, so that the bank is "accountable for the amount of" the item. § 4-302(a)(1). Thus, even if the bank acts in bad faith, it is not directly responsible for fully compensatory damages: its effort to dishonor is simply disregarded. Conversely, because the failed dishonor is wholly ineffective, the bank is responsible for the entire amount of the item even if the bank's failure was not caused by a failure to exercise ordinary care. Rejection of that rule could have serious consequences in a variety of areas. Among other things, it might have undesirable consequences in kiting cases.

Those provisions obviously raise significant policy questions about which reasonable minds will differ. Specifically, if the committee imports Regulation CC entirely, it will remove the responsibility of the payor bank for an item when the bank exercises ordinary care but fails to provide timely notice or return.

D. NOTICE IN LIEU OF RETURN

Both Regulation CC and Article 4 currently contemplate that all bounced checks will be returned to the depositary bank unless they are "unavailable." §§ 229.30(f), 229.31(f), 4-301(a)(2). Those rules impose a significant barrier to truncation of check processing, which eventually should result in checks being immobilized at some location rather than transported from bank to bank as they currently are. One of the originating motivations for this project was the Federal Reserve's perception that it was unable to implement a modernization of that rule without conforming amendments to the UCC.

Specifically, the Federal Reserve doubted its ability to implement regulations that would bind not only the affected banks, but also the drawer, payee, and depositor of the check. The cost savings involved provide a significant justification for truncation (or, farther in the future, wholly electronic or paperless checking). The principal issues for the Drafting Committee probably are (a) ensuring that customers have adequate information about charges against their account, a topic presently addressed in § 4-406(b) & cmt. 3); and (b) understanding the technology so as to permit future developments rather than restrict them. Those are issues on which the Drafting Committee may wish to seek input from affected industries, consumers, and professionals. On that point, it is worth noting that disagreement about the types of information consumers would receive after truncation is one of the problems that has kept New York from adopting the 1990 version of Articles 3 and 4.

E. Return Warranties

Regulation CC includes a number of warranties related to the return process. Generally, a bank that returns a check warrants to the depositary bank that the return has been executed properly, § 229.34(a), and a bank that sends a notice of nonpayment warrants that it has sent the notice properly and will return the check as required, § 229.34(b). Those warranties are a logical part of the return system, because, among other things, they make it prudent for the bank that receives a returned check or notice of nonpayment to rely on the returned check or notice as a basis for charging back the account of the depositing customer.

The UCC does not include any comparable provisions. Addition of those provisions was specifically mentioned by the Federal Reserve as a desirable change to the UCC. We see no significant policy questions raised by their addition to the UCC.

F. Indorsement Standards

Regulation CC imposes specific standards for indorsements. § 229.35(a) & (d). The UCC has nothing comparable. Again, this was something specifically mentioned as a desirable change to the UCC. We see no significant policy problems with uniform indorsement standards. The only difficulty is the drafting problem: how can we import into the UCC a relatively technical standard that is set in a Federal Reserve regulation and changes from time to time. {This is essentially the same problem as the check processing region problem mentioned above.}

G. LOSSES FROM BANK FAILURE

Regulation CC includes a short provision that allows a bank that fails to receive payment for a check because of the failure of another bank to shift the loss back to any earlier bank in the collection process. § 229.35(b). The UCC contains nothing comparable. The policy behind the provision might be contestable, but if the Drafting Committee accepts the provision as appropriate, it should be quite straightforward to add an analogous provision to Article 4.

H. MISCELLANEOUS

The last four sections of Regulation CC (§§ 229.40-229.43) appear to relate to issues that are less appropriate for inclusion in state law: date of effectiveness of mergers (§ 229.40), preemption of state law (§ 229.41), exclusions for federally related checks (§ 229.42), and special rules for Pacific islands (§ 229.43).

II. UNAUTHORIZED CHECKS

The classic rule for checks not authorized by the purported drawer dates to Lord Mansfield's holding in Price v. Neal, 971 Eng. Rep. 871 (K.B. 1762). That rule holds the payor bank responsible for any such item that it honors. The rule is implemented indirectly in the warranty provisions of Article 3 and 4 (by the omission of a presentment warranty that the draft was authorized, §§ 3-417(a)(3), 4-208(a)(3)), with a variety of exceptions that allow the payor bank to shift the loss to other parties that acted negligently or with knowledge of the forgery. §§ 3-406, 3-417(a)(3), 3-418. The rule rests on the functional notion that as between the payor bank and the depositary bank the payor bank is in a much better position to assess the signature on the item than the depositary bank, or (in a modern era) take other steps to ensure the validity of the item (such as positive-pay programs).

A. TELEPHONE OR "DEMAND" DRAFTS

The Committee's mandate includes two different potential limitations on that rule. The first relates to telephone drafts, sometimes called demand drafts – checks printed and signed by a merchant that has spoken with a customer by telephone and obtained oral permission to create the instrument. Several states, most notably California, have adopted rules (in the form of non-uniform amendments to the UCC) that allow the payor bank to shift those losses to depositary banks on the theory that the depositary banks are in the best position to police abuses of those instruments because they deal with the merchants that issue the drafts when they accept those drafts for collection on behalf of the merchants.

That reform raises some significant practical questions. If the purpose of the system is to put such losses on the banks in the best position to prevent them, the Committee might wonder whether the depositary bank can police those abuses through monitoring of its customers (the merchants) better than the payor bank can police them through positive-pay and similar programs. Industry representatives (both bankers and the telephone-merchant industry) and consumer representatives doubtless will have views on that point.

B. DEPOSITARY-BANK LIABILITY

More broadly, the Clearing House Association of the Southwest recently adopted a rule, which applies only to checks processed in its system, that directly rejects *Price v. Neal*. Specifically, a bank that presents a check for collection warrants that the check has no unauthorized signatures (and thus accepts responsibility for any losses that ensue if the check does have unauthorized signatures).

This topic directly raises the fundamental policy question at the heart of the UCC's current rules for allocating losses from forged signatures. As discussed above, the current law reflects a view that the payor bank is best situated to deal with that problem. The Clearing House Association of the Southwest rule reflects a view that the depositary bank is best situated to deal with that problem. The willingness of that association of financial institutions to adopt the rule suggests at a minimum that it is plausible to think that depositary banks as a class can solve the problem more effectively (by knowing the customers from whom they accept deposits) than payor banks (by knowing the signatures and check-writing wishes of their customers). It is important to understand that the rule has no substantial effect on consumers: its only direct effect is to shift the loss from one bank (the payor bank) to another (the depositary bank). It would affect some customers, though, such as merchants and check-cashing services that take the forged checks and thus might (depending on the revision) be charged with making a no-forgery warranty when they deposit the forged checks. {Because depositary banks are better placed to recover forged-check losses from the depositors than payor banks (who have no relation with the depositors), it might have an indirect effect on consumers by enhancing the ability of the banking system to recover those losses from the bad actors. That effect, however, is wholly salutary.}

III. ELECTRONIC COMMUNICATIONS

Articles 3 and 4, like all of the original UCC, proceeds on the premise that many important communications will be made in writing. In an age in which electronic communication is increasingly prevalent, reexamination of that premise seems prudent. The specific occasion for reexamination is NCCUSL's recent promulgation of the Uniform Electronic Transaction Act ("UETA"). Section 7 of that Act generally provides that neither "[a] record or signature" nor a contract "may * * * be denied legal effect or enforceability solely because it is in electronic form." The UETA by its express terms, however, does not apply to matters governed by Articles 3, 4, 4A, 6 or 7 of the UCC. *See* UETA § 3(b)(2) & cmt. 5. One of the tasks of the Committee is to parse through those Articles to determine the extent to which a similar policy could be implemented in those Articles. {The work related to Articles 6 and 7 is delegated to the Committee because of the lack of a present revision project for those Articles.}

Given the great labor and thought that went into the UETA, it seems unlikely that the Committee will reject its premise that statutes of frauds and related provisions should be relaxed to accept electronic communications. Accordingly, the work of the Committee presumably will start from the premise that most references to writings, records, and communications can be satisfied by communications in an electronic format. It would be useful if the Committee could resolve that basic policy question at its first meeting. If it did so in a way that generally accepts the analysis of the UETA, the task that would remain for the Committee would be to examine each of the relevant provisions of Articles 3, 4, 4A, 6, and 7 to determine in which (if any) circumstances an electronic record or signature should not suffice. If the Committee agrees with that approach, then the Reporter before the next meeting would (a) draft language that incorporated the UETA's basic definitional apparatus into the relevant UCC articles; (b) prepare a list of provisions for which electronic records and signatures seem adequate; and (c) identify those provisions for which electronic records and signatures might be inadequate. To get a sense for the scope of the project, you should know, based on information from Neil Cohen, that the issue appears in at least 9 sections in Article 3, 5 sections in Article 4, 5 sections in Article 4A, 6 sections in Article 6, and 5 sections in Article 7.

IV. ELECTRONIC INSTRUMENTS

Article 3 indirectly requires all negotiable instruments to be in writing. All instruments must be either a promise or an order (§ 3-104(a)) and all promises and orders must be in writing, § 3-103(a)(6) & (9). Because the law accords a variety of important benefits to negotiable instruments that are not available to nonnegotiable obligations (holder-in-due-course status, procedural advantages, etc.), the requirement that instruments be in writing limits the extension of those benefits to systems of electronic obligations that might develop.

The principal questions for the Drafting Committee are whether (a) there is a discernible policy reason to limit negotiability to written instruments; and (b) if not, whether there is a sufficiently clear likelihood that such systems would develop to make it worthwhile and feasible to provide statutory support at this time. On the first point, the Committee members doubtless will have their own views, which we can discuss at the April meeting. Among other things, the Committee might consider the various practical and regulatory limitations that have caused negotiable instruments to disappear from common use in many contexts, particularly those that involve consumers. To the extent that those rules prejudice consumers, they might be uncontroversial now only because they have relatively little practical application. If that is true, a revision significantly expanding the practical availability of negotiability would (rightly or wrongly) be viewed as adverse to makers.

On the second point, it doubtless would be useful to hear the views of affected professionals. Among other things, we should consider whether the considerations might be different for electronic notes and electronic drafts. The provisions in Article 9 about electronic chattel paper (§§ 9-102(a)(31), 9-314(a)) seem to presage a reasonably prompt development of electronic notes. Given the rapid development of wholly electronic functional substitutes for checks (either by truncation at the register, resulting in an ACH item, or by use of a debit-card), it is less clear that electronic drafts are likely to develop in the next few years. The most likely venue for such a development probably would be in the context of cross-border documentary transactions, where the BOLERO project for electronic bills of lading is making significant process. Input from knowledgeable professionals doubtless would be useful on that point.

V. PAYMENT AND DISCHARGE

Section 3-602 generally provides that payment of a note discharges the obligation on the note only if the payment is made to a person entitled to enforce the note. Thus, if the payee transfers the note and the maker subsequently makes a payment to the original payee (rather than the transferee that is at the time of the payment entitled to enforce the note), the payment is ineffective. The recently promulgated *Restatement of Mortgages* rejects that rule in Section 5.5, which generally provides that after the transfer of a mortgage note, a payment made to the transferor is effective if it is made before the obligor receives notice of the transfer. The policy intuition behind the revision is that it is easier for a transferee to ensure that the obligor receives notice of the transfer than it is for an obligor to check each month to make sure that it is paying the right party. *See* RESTATEMENT OF MORTGAGES § 5.5 cmt. a, at 390. Similar rules also appear in the current *Restatement of Contracts* (RESTATEMENT OF CONTRACTS (2D) § 338(1)) and in the newly promulgated Article 9, § 9-406(a).

Because § 3-602 articulates a contrary rule, the *Restatement of Mortgages* rule is expressly inapplicable to negotiable instruments. *See* RESTATEMENT OF MORTGAGES § 5.5 cmt. b, at 392-95. The Committee faces two questions. First, does it wish to accept the policy judgment reflected in the *Restatement of Mortgages*. The *Restatement* rule does impose an additional burden on transferees of notes, which they do not bear under current Article 3 rules; the question for the Committee is whether the benefit to obligors (certain knowledge of the proper party to whom they should make payments) justifies that burden. If so, the second question is whether the Committee wishes to limit the range of notes to which the new rule might apply. For example, should it apply only to notes secured by real estate (a reform limited to removing the incongruity of the partial reach of the *Restatement of Mortgages* rule) or should it apply more broadly (a reform that extends the policy judgment of the *Restatement of Mortgages* throughout the range of negotiable instruments to match the general policy judgment of the *Restatement of Contracts*).

VI. SURETYSHIP

In 1996, the ALI promulgated the *Restatement (Third) of Suretyship and Guaranty*. In the course of the work leading up to that document, it became apparent that there was some tension between the suretyship rules articulated in Article 3 and more general principles of suretyship law. The Committee is charged with considering whether those tensions justify any revisions to Article 3. The principal problems are summarized briefly in the paragraphs that follow, with some effort to proceed in decreasing order of apparent significance.

A. Reservation of Rights

The 1990 version of Article 3 rejects the reservation of rights doctrine: a settling creditor that grants a discharge to the primary obligor no longer need "reserve its rights" against the obligor to retain its right to pursue the surety: the creditor that discharges the obligor entirely can pursue the surety whether or not it reserves its rights. § 3-605(b). The general purpose is to enhance the flexibility of a creditor attempting to negotiate with a distressed borrower to whom it might grant a discharge; the revision permits a complete discharge to the borrower with no risk of an effect on the creditor's rights against the surety. It is clear that the drafters intended a significant change from the general law of suretyship. The comments suggest, however, that the surety remains free to pursue the principal if the surety later pays the creditor; that rule lessens considerably the change effected by the revisions. § 3-605 cmt. 3.

With the benefit of hindsight, we now can see two problems with the revisions. First, the most important part of the new substantive rule appears only in the comment, which leaves the statutory text somewhat misleading. {Some of the material in the comments was added by PEB Commentary 11 (Issue 6).} Second, we now can see that the *Restatement of Suretyship* has adopted quite a different approach, under which the secondary obligor is discharged to the extent of its harm, without regard to the "magic-words" approach of the traditional common-law rule. The Committee should consider whether it wishes to move Article 3 closer to the rules reflected in the *Restatement of Suretyship*. If it does not, it then should consider whether clarifying the statutory intent is appropriate.

B. Suretyship Defenses

In contrast to § 3-605(b), the later subsections of 3-605 (3-605(c) & (d)) restrict the flexibility of the creditor – they leave the creditor open to the possible discharge of the surety *even if* the surety does reserve its rights. The provisions are parallel to § 3-605(b) in that they reject the reservation-of-rights doctrine, but the overall effect is to create some odd incentive effects that are not justified by any obvious policy difference. For example, the creditor that discharges a debtor entirely has no risk of loss of its rights against the surety, while the creditor that grants the one-week extension does.

Again, the Committee should consider whether it wishes to move Article 3 toward the modern approach reflected in the *Restatement of Suretyship*. The *Restatement* adopts an across-the-board harm standard – arrangements between the creditor and the principal obligor discharge the surety if they cause harm to the surety. A revision of Article 3 to provide a more unitary approach arguably would be more coherent.

C. Obligation of the Accommodation Party After a Change in the Primary Obligation

Because the 1990 version of Article 3 adopts a system under which a change in the obligation of the accommodated party can result in a partial (rather than complete) discharge of the accommodation party, it raises a question as to the precise parameters of the accommodation party's obligation. Article 3 does not address that topic, but the *Restatement* does. The Committee might wish to consider that topic.

D. Rights Against the Obligor

Old Article 3 did not grant the surety any right of reimbursement (the surety's right to recover payments made to the creditor) or exoneration (the surety's right to force the primary obligor to perform). The 1990 version of Article 3, however, expressly added a right of reimbursement. It did not, however, address the right of exoneration, which leaves the statute open to the interpretation that the right of exoneration is intended to be barred. Clarity seems called for on that point. PEB Commentary 11 (Issue 2) added some language to § 3-419 comment 5 to address the point (suggesting that exoneration should be available). If the Committee thinks exoneration inappropriate for negotiable instruments, it should revise the statute to reach that result. If the Drafting Committee wishes to permit exoneration, it might be appropriate to go beyond the existing comment and alter the statute to reach that result expressly.

E. Waiver of Suretyship Defenses

Section 3-605(i) generally permits the surety to waive the defense of impairment of collateral. Because the definition of impairment of collateral includes "failure to comply with applicable law in disposing of the collateral," § 3-605(g), the Article 3 provision arguably is inconsistent with the limitation in § 9-624 limitations on the ability of an obligor to waive the Article 9 rules on disposition of collateral. {A surety is an "obligor" under Article 9. § 9-102(a)(59) & (71).} Unless the Committee wishes to reject the policy judgment of the Article 9 project, it might be useful to clarify the provision in Article 3 to conform to the Article 9 rule. {PEB Commentary 11 (Issue 11) added some language to § 3-605 cmt. 8 to address that problem, but an express statutory revision might be appropriate.}

F. Against Whom May Suretyship Defenses Be Asserted

Under the old Article 3, an accommodation party could assert suretyship defenses against a party if the party had "notice" of the accommodation. The 1990 version of Article 3, however, generally allows an accommodation party to assert those defenses only if the person entitled to enforce the instrument "knows" of the accommodation. § 3-605(h). The distinction between knowledge and notice is given considerable weight by § 1-201(25). The Neil Cohen (Reporter of the *Restatement of Suretyship*) has suggested that the change is inappropriate, particularly in light of the difficulty in determining whether a party is an accommodation party because of an "anomalous" indorsement under § 3-205(d) and 3-419(c). The Committee should consider whether some response to that problem would be appropriate.

G. Definition of Accommodation Party

Section 3-419(a) relies on a vague distinction "between direct and indirect benefit" to determine whether a party that signs the instrument is a surety (an "accommodation party" in Article 3 terminology) instead of a primary obligor. *See* § 3-419(a) & cmt. 1. That distinction is difficult to apply in some obvious cases, such as the case where the putative accommodation party benefits in a cognizable way from the advancement of funds to the primary obligor. For example, Neil Cohen posits the case in which a daughter that lives with her father cosigns a note that he gives to the landlord for back rent. Instinct suggests that she is an accommodation party, but she arguably receives a direct benefit (from the landlord's decision not to evict for failure to pay the back rent). It is possible (though not entirely clear) that the situation could be improved by the addition of some hypotheticals to the comments or, perhaps, by a more specific statutory delineation of the type of benefit that should count as "direct" for purposes of § 3-419(a).

H. Payment Guaranties

The 1990 version of Article 3 omits the concept of the payment guaranty that appeared in old § 3-416(1). Essentially that concept allowed an indorser to waive the requirements of presentment and dishonor. It is not clear that the omission was intentional. If the concept would have any commercial significance, it might be appropriate to return it to the statute.

I. Suretyship Defenses for Sureties that Are Not Accommodation Parties

Section 3-605(f) articulates rules for impairment of collateral when parties are jointly and severally liable for debts. That situation does not involve accommodation parties under Article 3 because each of the parties are directly obligated for a portion of the instrument. Because the statute grants a suretyship defense for impairment of collateral in that situation, but does not address other suretyship defenses, it might be read to preclude other suretyship defenses. The Committee should consider whether revisions to the statute or comment are appropriate to clarify the intent of the statute.

VII. TRANSFERRING LOST INSTRUMENTS

Section 3-309 sets the conditions under which a party can enforce a lost or stolen instrument. Among other things, the statute requires that the party have been in possession at the time the instrument was lost. § 3-309(a)(i). Read literally, that provision poses a significant difficulty to the receiver of a failed bank that is unable to locate all of the notes held by the bank. Specifically, if the receiver transfers the assets of the bank to a third party, a literal reading of the statute suggests that the third party cannot enforce any lost notes because the third party was not in possession when the note was lost. *See* Dennis Joslin Co. v. Robinson Broadcasting, 977 F. Supp. 491, 494-95 (D.D.C. 1997) (applying that reasoning); *see also* McCay v. Capital Resources Co., 940 S.W.2d 869, 870-71 (Ark. 1997) (alternate holding); Western Nat'l Bank v. Rives, 927 S.W.2d 681 (Tex. Ct. App.—Amarillo 1996) (dicta, applying old Article 3). Several courts, however, have rejected that reasoning. *See* Southwest Investments, Inc. v. Cade, 1999 WL 476865 (N.D. Tex. July 7, 1999); Beal Bank, S.S.B. v. Caddo Parish-Villas South, Ltd., 218 B.R. 851, 853-55 (N.D.Tex. 1998); NAB Asset Venture II, L.P. v. Lenertz, Inc., 36 UCC Rep. Serv. 2d 474, 478-79 (Minn. Ct. App. 1998).

Any expansion of § 3-309 has the potential for unfair treatment of makers of promissory notes, who are presented with litigation under the advantageous rules of Article 3 by a party that cannot demonstrate its entitlement to sue by possession of the original note. On the other hand, the result in *Dennis Joslin Co.* is troubling at best. Because the FDIC (as successor to the rights of the failed institution) plainly could enforce the note if it retained the assets of the bank in its own hands, it gives a windfall to the maker of the note to provide for a different result in the hands of the purchaser of the bank. Given the importance to the FDIC's operations of the kind of purchase-assumption transactions in which those issues arise, and given the likely frequency of lost notes in the records of failed banks, the problem seems ripe for correction. The principal question would be whether to limit the relief in some way (perhaps to a transfer by a receiver for a failed financial institution) or instead to broaden § 3-309 to permit such transfers generally.

VIII. MISCELLANEOUS

The Committee's mandate also includes the authority to consider miscellaneous issues if they are significant and likely to cause mischief. If the Committee is to finish its work promptly, the first meeting should focus the Committee's agenda on specific issues that the Committee will address. The remaining sections of this memorandum summarize the miscellaneous issues that have been presented to NCCUSL and ALI that seem sufficiently serious to justify consideration by the Committee. The topics are organized by the most likely location of a revision to the UCC.

A. Definition of Bank (§ 1-201(4))

Because the definition of bank in § 1-201(4) is limited to "any person engaged in the business of banking," the rules of Article 4 are limited to banks. Given the many types of non-bank depositary institutions that have developed in the last few decades, the limitation of Article 4 to banks has come into question. *See* Edward D. Jones & Co. v. Mishler, 38 UCC Rep. Serv. 2d 1091 (Ore. Ct. App. 1999) (interpreting old Article 4 to apply to a non-bank investment entity).

B. Legended Checks **(§ 3-104(c))**

Section 3-104(c) provides that a check can be an instrument even if it does not include order language. As the comment explains, that ordinarily occurs because the maker crosses out the order language on the preprinted check form. § 3-104 cmt. 2. The rationale for that rule is that banks using current check-processing practices cannot reasonably be expected to notice that type of writing on a check. It happens, however, that customers often write other things on checks ("Void after 90 days" "Not good for over $1,000"). The rationale for § 3-104(c) would apply to those legends as well, but they plainly are not protected by that provision. The questions for the Committee are (a) whether to extend the policy reflected in § 3-104(c) more broadly; and (b) how the extension might be limited to accommodate business practices dependent on such legends.

C. Foreign-Currency Instruments **(§ 3-107)**

With the advent of the Euro, the individual European currencies will disappear in the years to come. Representatives of the Federal Reserve Board have raised the possibility of revisions to address payments due on country-denominated instruments after the applicable currencies cease to exist. Section 3-107 states that payment can be made in dollars at the applicable spot price. The Committee might consider whether to permit (if not require) payment in the successor currency (the Euro) rather than dollars. Among other things, the difficulty arises that there may not be a well-functioning spot price for French francs (for example) after the franc ceases to exist.

D. Definition of Negotiation **(§ 3-201(a))**

Suppose that A writes a check but leaves the payee line blank. If Thief steals the check, is Thief a holder? General principles suggest that the answer should be yes because the check is bearer paper and Thief is in possession. But §§ 1-201(20) and § 3-201(a) suggests that a party can become a holder only by negotiation and that a transfer of possession by the issuer (as opposed to an issue of the instrument) does not constitute negotiation. It might be appropriate to revise the statute to clarify that Thief would be a holder.

E. Definition of Holder/Indorsement **(§ 3-205(a))**

The definition of holder in § 1-201(20) has been criticized because of doubts about the significance of indorsement in determining the party that is an identified person. For example, suppose that an instrument is issued by A payable to B, given to C without indorsement, and then transferred to D with a special indorsement stating "Pzyable to D. /s/ C." Some have argued that under § 1-201(20), D is a holder because (I) this is an "instrument payable to an identified person," and (II) C's indorsement makes D the identified person. It seems fairly clear, however, that D should not be the holder (because (I) the instrument originally was order paper payable to B; (II) B is not in possession; and (III) B has not indorsed the instrument to another party.

It appears, however, that the statute already reaches the correct result under § 3-205(a), which states that when a holder makes a special indorsement that "identifies a person to whom it makes the instrument payable," the "instrument becomes payable to the identified person." It might be useful, however, to add a clarifying reference to the comments to § 3-205.

F. Fiduciary Checks **(§ 3-307)**

Section 3-307 provides that an institution is liable in certain circumstances if it permits a person to deposit a check made out in a fiduciary capacity into the individual's personal account. The Social Security Administration has written to NCCUSL explaining that the statute causes significant difficulty for Social Security Checks commonly made out to parents as guardians of minor children, with the expectation that the checks would be deposited in the parents' accounts. Section 3-307 has caused some institutions to refuse to accept those checks for deposit. That unfortunate result seems far from the original intent of § 3-307. The Committee should consider whether remedial action is appropriate.

G. Transfer Warranty by Remitter **(§ 3-416(a)(1))**

A person that obtains a cashier's check to pay an obligation is not ordinarily a person entitled to enforce the instrument (made payable to the obligee); rather, it is a remitter. §§ 3-103(a)(11), 3-301. Thus, whenever such a person transfers a cashier's check it breaches the warranty in 3-416(a)(1). That seems uncalled for, and appears to arise inadvertently out of a shift in the language of the transfer warranties from the old Article 3, which talked about good title, which our cashier's-check purchaser would have. A small revision to § 3-416(a)(1) might be appropriate.

H. Comparative Negligence (§ 4-208(c))

The 1990 version of Articles 3 and 4 generally adopt a regime of comparative negligence for the various check-preclusion rules. *See* §§ 3-404(d), 3-405(b), 3-406(b), 4-406(e). To ensure that drawers bear responsibility under those provisions, § 4-208(c) provides that a payor bank cannot pass a loss back as a breach presentment warranty if the payor bank could have held the drawer responsible under one of those provisions. Section 4-208(c) does not, however, deal well with a case in which both the drawer and the depositary bank bear some responsibility. For example, consider a case (such as *Garnac Grain Co. v. Boatmen's Bank & Trust Co.*, 694 F. Supp. 1389 (W.D. Mo. 1988) (decided under the old Articles 3 and 4) (discussed in WHITE & SUMMERS § 16-7 (5th ed. 2000)), in which an employer embezzled more than $2 million by forging and altering checks. The employer was negligent in hiring and supervising her (she previously had served jail time for her third check-fraud offense); the depositary bank was negligent in not noticing the crude alterations.

It seems fairly clear that the intent of the 1990 version of Article 3 and 4 is that (assuming all parties are solvent) the negligent parties should bear their respective shares of the loss: if the payor bank is 20% responsible, the depositary bank 30% responsible, and the drawer 50% responsible, the loss should fall that way. It is difficult, however, to read § 4-208(c) to permit that result. The principal difficulty is that § 4-208(c) does not seem to provide for that kind of proportionate recovery by the payor bank against the depositary bank in a case in which there is a preclusion under any of the check-preclusion provisions in Articles 3 and 4. *See* § 4-208(c) ("[T]he warrantor [that is, the depositary bank] 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.").

The questions for the Committee are (I) whether it agrees that the comparative-negligence approach is correct in a case like *Garnac*; and (II) whether the problem is sufficiently serious to warrant attention. It is worth noting that the comparative-negligence provisions are one of the items that seem to have been the basis for New York's refusal to adopt the 1990 version of Articles 3 and 4.

I. Collection Items (§ 4-302)

Section 4-302 imposes deadlines on a payor bank only for demand items, not for collection items. The question arises whether Article 4 should address that topic by adopting the same rules or some different set of rules. Consideration of that topic doubtless would be aided by information about current practice and the extent to which ICC publications (in particular, ICC Publication

522, *Uniform Rules for Collections*) adequately govern the issue.

J. Definition of Properly Payable (§ 4-401)

The definition of properly payable in § 4-401 leaves a number of things unstated. Most obviously, it does not specify how a bank is to respond to a check with a break in the chain of indorsements. If the check was stolen and bears a forged indorsement, it seems clear (although the statute does not say so) that the check is not properly payable. A harder question is whether an item is properly payable if an indorsement is missing because of a transfer without indorsement under § 3-203(b): suppose I give a check to my brother without indorsing it. Under § 3-203(b) he becomes a person entitled to enforce. Thus, you would think, the payor bank would act wrongfully in dishonoring the item. On the other hand, the Committee might think that the payor bank should be within its rights in dishonoring the item based on the absence of the indorsement. A general clarification of the topic might be fruitful.

K. Wire-Transfer Errors (§ 4-402(b))

Article 4 generally permits consequential damages for wrongful dishonor. § 4-402(b). Article 4A generally bars consequential damages in the absence of an express agreement calling for them. § 4A-305(c). The difficulty is what to do when a wire-transfer error (either an erroneous transfer out of an account or an erroneous failure to credit an incoming transfer) leads to dishonor of an Article 4 item. The UCC provides “no specific guidance” on that question. *See* § 4-402 cmt. 2. The Committee might wish to consider whether experience under Article 4A suggests a proper way to address that issue.