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Uniform Commercial Code - Commercial Paper Part II - Transfer and Negotiation

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Uniform Commercial Code--Commercial Paper

Part II—Transfer and Negotiation

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In a previous article[1] the writer undertook the task of outlining briefly the changes to be wrought in existing law by the proposed Uniform Commercial Code in relation to the subject of negotiable instruments. The present paper is a continuation of that study and will deal with the transfer and negotiation of commercial paper, which are governed by Part 2, Article 3, of the Uniform Commercial Code. While Part 2 is quite brief, and deals chiefly with the mechanics of transfer and negotiation, some important changes in the law have been proposed.

TRANSFER: RIGHT TO INDORSEMENT[2]

The first section of Part 2,[3] combines the provisions of §§ 27,[4] 49,[5] and 58,[6] of the N.I.L., and deals with transfers involving other than technical negotiations. One of the purposes of the section is to incorporate expressly in the Code fundamental principles of property and contract law widely recognized in existing case law.

For example, the gift cases illustrate the proposition that delivery with donative intent passes title even to an order instrument not properly indorsed.[7] Clearly the transferee for value should fare as well, and in either type of transfer the

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1 Tisdale, *Uniform Commercial Code — Commercial Paper*, 26 N.D. Bar Briefs 252 (July, 1950).

2 All references are to the Uniform Commercial Code, Proposed Final Draft No. 2, Text Edition, Spring, 1951. To conserve space the present Uniform Negotiable Instruments Act will be cited "N.I.L." and the proposed code as "U.C.C."

3 U.C.C. § 3-201. "(1) Transfer of an instrument vests in the transferee such rights as the transferor has therein, except that a transferee who has himself been a party to any fraud or illegality affecting the instrument or who as a prior holder had notice of a defense or claim against it cannot improve his position by taking from a later holder in due course.
(2) A transfer of a security interest in an instrument vests the foregoing rights in the transferee to the extent of the interest transferred.
(3) Unless otherwise agreed any transfer for value of an instrument not then payable to bearer gives the transferee the specifically enforceable right to have the unqualified indorsement of the transferor. Negotiation takes effect only when the indorsement is made and until that time there is no presumption that the transferee is the owner."

4 N.D. Rev. Code § 41-0304 (1943).

5 N.D. Rev. Code § 41-0420 (1943).

6 N.D. Rev. Code § 41-0508 (1943).

7 Rothwell v. Taylor, 303 Ill. 226, 135 N.E. 419 (1922).

transferee has property rights which he can pass on to third parties.[8] This section makes it clear that a transferor need not be a holder by providing that "Transfer of an instrument vests in the transferee such rights as the transferor had therein . . ."[9]

Unfortunately the language of the N.I.L. does not clearly require the results outlined above. By providing that ". . . Where the *holder* of an instrument payable to his order *transfers it for value* without indorsing it . . .", §49[10] of the N.I.L. makes it possible to draw at least two negative inferences: first, a mere transferee cannot pass on his rights; second, a donee gets no title if he takes by transfer. While some authorities exist which lend support to each of these propositions, North Dakota law would appear to be contra,[12] and the Code definitely rejects both positions.[13]

This section of the Code draws a clear line between the substantive and procedural rights of a holder as contrasted with those of a mere transferee—again a distinction not too clearly indicated in the N.I.L., but clearly defined in case law. Thus §51[14] of the N.I.L. permits a holder to sue in his own name, §57[15] frees him of all but real defenses, and § 59[16] provides that every holder is ". . . deemed prima facie to be a holder in due course . . ." Obviously no such presumption will arise from the fact of possession by a mere transferee since the instrument indicates on its face that title is in a third party,

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[8] Section 49 of the N.I.L. would appear to vest title in the transferee, and having title he is entitled to sue in his own name. An "ourselves" note illustrates the problem nicely. Although the N.I.L. requires indorsement to complete such an instrument, yet the weight of authority considers that a transferee may sue. Cassetta v. Banna, 106 Cal.App. 196, 288 Pac. 830 (1930); Armato v. Ross, 170 So. 400 (La.App.1936). *Cf.* People's State Bank v. Snyder, 50 N.D. 234, 195 N.W. 436 (1923).

[9] Note 3, *supra*. Section 49 of the N.I.L. makes the *title* pass. The U.C.C. substitutes *rights*—a more inclusive term.

[10] N.D. Rev. Code § 41-0420 (1943).

[11] That indorsement is necessary to pass title to an order instrument see: Moore v. Moore, 35 Ga.App. 39, 131 S.E. 922 (1926) Bond v. Maxwell, 40 Ga.App. 679, 150 S.E. 860 (1929). *Contra*, Cosmopolitan Trust Co. v. Leonard Watch Co., 249 Mass. 14, 143 N.E. 827 (1924). That an oral assignment of a note to an agent for collection makes him the real party in interest, see: Hagge v. Drew, 73 Cal.App.2d 739, 167 P.2d 263 (1946); Nisewanger v. W. J. Lane Co., 75 N.D. 448, 28 N.W.2d 409 (1947). There is some authority supporting the first negative inference. Simon v. Mintz, 51 Misc. 670, 101 N.Y.Supp. 86 (1906). *Cf.* Kiel Wooden Ware Co. v. Laun, 233 Wis.559, 290 N.W. 214 (1940). *Contra*, cases cited Note 8, *suppra*.

[12] See note 11, *supra*, and Baird v. Chamberlain, 60 N.D. 784, 236 N.W. 724 (1931).

[13] The code substitutes "rights" for "title" of the transferor, and no longer requires that it be a transfer for value. U.C.C. § 3-201 (1).

[14] N.D. Rev. Code § 41-0501 (1943).

[15] N.D. Rev. Code § 41-0507 (1943).

[16] N.D. Rev. Code § 41-0509 (1943).

and one who may not be a party to the suit. While there is some authority that possession raises a presumption of ownership as against the obligor,[17] the better view is that the burden rests on the transferee to allege and prove his title, and the North Dakota cases so hold.[18] Hence the Code, after giving the transferee a specifically enforceable right to an unqualified indorsement,[19] concludes: "Negotiation takes effect only when the indorsement is made and until that time there is no presumption that the transferee is the owner."[20]

Another important clarification of the law found in this section involves the "shelter" clause in § 58[21] of the N.I.L., and incorporated here because it deals with the rights of a transferee. This section provides that "a holder who derives his title through a holder in due course, and who is not himself a party to any fraud or illegality affecting the instrument, has all the rights of such former holder in respect of all parties prior to the latter."

The bona fide purchaser doctrine has a special application in the field of negotiable paper. To insure a free market for commercial paper, we protect one who claims through a holder in due course.[22] But when the rights of a re-acquirer are in question we face a question of policy—if the re-acquirer has participated in the fraud we cannot permit him to take advantage of the shelter clause.

Clearly, if the payee was subject to the defense of fraud or other equitable defense, he should be remitted to his former rights, since it would be inequitable to permit him to pass the instrument on to a holder in due course and thus

[17] Manhattan Chamber of Commerce v. Gallagher, 123 Kan. 155, 254 Pac. 345 (1927); Southwest General Electric Company v. Riddle, 66 Okla. 202, 168 Pac. 436 (1917). Cf. Baird v. Perry, 56 N.D. 594, 218 N.W. 229 (1928).

[18] Shepard v. Hanson, 9 N.D. 249, 83 N.W. 20 (1900); Williams v. Clark, 42 N.D. 107, 172 N.W. 825 (1919).

[19] U.C.C. § 3-201 (3) applies only to transfers for value. A donee is not entitled to an indorsement under this section. Section 49 of the N.I.L. has the same limitation. The only change is that the right is now to become enforceable in equity.

[20] U.C.C. § 3-201 (3).

[21] N.D. Rev. Code § 41-0508 (1943).

[22] "This doctrine rests on the following considerations: When negotiable paper comes into the hands of a holder in due course, that person takes title free from all equities existing between prior parties. In order that he may be given the full commercial benefits of that complete ownership, and have the whole world as a market, the law usually permits him to transfer without reservation all of his rights, powers, privileges and immunities to any transferee normally, therefore, his immunities from prior equities must continue in favor of his transferee, otherwise the marketability of his paper would be seriously restricted." Note, 1 N.C.L.Rev. 187-191 (1923).

cleanse it of a defense of which he had full knowledge.[23] If, however, the payee negotiates to a holder in due course who transfers without indorsement, the transferee receives the full benefit of the shelter clause despite knowledge of the defense and whether or not he gave value.[24] This is the bona fide purchaser principle in its essence—but can clearly be distinguished from the case of the re-acquirer. After all the transferee simply took advantage of the good fortune of another, and his act has in no way worsened the position of the obligor. But the re-acquirer, with notice of the fraud when he took the instrument, has attempted to better his position by passing it on. Essentially the question is, whether a holder with notice becomes a party to the fraud by shooting the instrument thru a holder in due course.[25] The Code takes the view that a holder "who as a prior holder had notice of a defense or claim against it cannot improve his position by taking from a later holder in due course."[26] The clause clears up any possible doubt that it is fraud to try to wipe out the effect of notice.[27] Of course it still remains true that a holder in due course re-acquiring the instrument takes free of defenses.[28]

This section combines in one section of the Code three widely separated sections of the N.I.L. which deal with the rights of a transferee. It makes it clear that rights pass on transfer—all the rights that the transferor had—and this of course covers a transfer of a limited security interest.[29] The net effect appears to be a clear improvement over the N.I.L. and involves no radical change in existing law.

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[23] Britton, Bills and Notes § 124 (1943); Beutel's Brannan Negotiable Instruments Law § 58, p. 855 et seq. (7th ed.1948); Note, 54 L.R.A. 673 (1902).

[24] See note 22, *supra.*

[25] In view of the holding that a taker with notice from a holder in due course takes free of defenses, it is arguable that § 58 of the N.I.L. would permit a reacquiring holder who first took with notice to recover free of defenses. There is authority to this effect. See Horan v. Mason, 141 App.Div. 89, 125 N.Y.Supp. 668 (1910).

[26] U.C.C. § 3-201 (1).

[27] The cases are not agreed on the theory which prevents recovery by a re-acquiring party who took with notice. Some authorities hold that a maker compelled to pay the note to a holder in due course has a cause of action against the payee. Gates v. Ritchie, 162 Ark. 484, 258 S.W. 397 (1924); Patterson & Co. v. Peterson, 15 Ga.App. 680, 84 S.E. 163 (1915). *Contra,* Dickinson v. Carroll, 21 N.D 271, 130 N.W. 829 (1911).

[28] Section 48 of the N.I.L. permits a former holder to strike out any indorsement not necessary to his title. The effect of this, of course, is to discharge that party and all parties subsequent to him. This restores the reacquirer to the position he held originally. If a holder in due course then, he remains a holder in due course despite subsequent notice. The statute has its application where the reacquirer seeks to improve his position by relying on the title of a later indorser in point of time.

[29] Baird v. Chamberlain, 60 N.D. 784, 236 N.W. 724 (1931).

NEGOTIATION

Section 3-202[30] of the Code combines and rewords sections 30,[31], 31[32] and 32[33] of the N.I.L. While § 1 of Part II deals with transfers, the second section deals with a special kind of transfer—negotiation is a transfer that results in making the transferee a holder. Thus no change in existing law is envisaged, merely a rearrangement and clarification of the provisions of the N.I.L. It still remains true that a bearer instrument, or one where the only or last indorsement is in blank and all prior special indorsements are in order, is transferable by delivery. On the other hand, a special indorsement controls even where the instrument is bearer paper on its face, a point to be taken up later.[34]

The Code follows the N.I.L. in requiring indorsement on the instrument or on a paper firmly affixed thereto for the purpose of receiving indorsements. It rejects the adequacy of any attempted indorsement of an accompanying document attached to the note such as a contract or mortgage, etc.[35]

In accord with existing law, the statute expressly states that "An indorsement must be written by or on behalf of the holder" . . . thus setting out expressly in the statute a principle familiar to all but set out only inferentially in the N.I.L.[37]

Section 32 of the N.I.L.[38] requires an indorsement of the entire interest of the holder and does not permit a partial assignment to operate as a negotiation. The Code continues

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[30] U.C.C. § 3-202. "Negotiation. (1) Negotiation is the transfer of an instrument in such form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with any necessary indorsement; if payable to bearer it is negotiated by delivery.
(2) An indorsement must be written by or on behalf of the holder and on the instrument or on a paper so firmly affixed thereto as to become a part thereof.
(3) An indorsement is effective for negotiation only when it conveys the entire instrument or any unpaid residue. If it purports to be of less it operates only as a partial assignment.
(4) Words of assignment, condition, waiver, guaranty, limitation or disclaimer of liability and the like accompanying an indorsement do not affect its character as an indorsement."

[31] N.D. Rev. Code § 31-0401 (1943).

[32] N.D. Rev. Code § 31-0402 (1943).

[33] N.D. Rev. Code § 31-0403 (1943).

[34] U.C.C. § 3-204, *infra* note 45.

[35] Bergmann v. Puhl, 105 Wis. 120, 217 N.W. 746 (1928).

[36] U.C.C. § 3-302 (2), note 30, *supra*.

[37] See N.D. Rev. Code § 1-0149 (5) (1943): "'Signature' or 'Subscription' shall include 'Mark' when the person cannot write, his name being written near it and written by a person who writes his own name as a witness." That this section is of general application, see Montague v. Street, 59 N.D. 618, 231 N.W. 728 (1930).

[38] N.D. Rev. Code § 31-0403 (1943).

this rule by stating that "an indorsement is effective for negotiation only when it conveys the entire instrument or any unpaid residue. If it purports to be of less it operates only as a partial assignment."[39] The phrase "which purports to transfer the instrument to two or more indorsees severally . . ."[40] is omitted as superfluous since covered in other portions of the Code. It is a proper procedure to indorse to A and B as tenants in common. An instrument payable to A or B is payable to either, and the same rule should govern on indorsement.[41]

Subsection three of the Code is new, but states a well recognized rule—that the addition of "words of assignment, condition, waiver, guaranty, limitation or disclaimer of liability . . . do not affect its sufficiency for negotiation. This does not represent a change in North Dakota law so far as words of guaranty are concerned.[42]

Section 43[43] of the N.I.L. provides: "Where the name of a payee or indorsee is wrongly designated or misspelled, he may indorse the instrument as therein described, adding, if he think it fit, his proper signature." Sec. 3-202[44] rewords this section but makes no change in the law. The change in language is to make it clear that while indorsement in either the erroneous designation, or in the holder's correct name would be sufficient to pass title, the purchaser has a right to demand both signatures. Undoubtedly that corresponds with sound commercial practice.

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[39] U.C.C. § 3-302 (3), note 30, *supra.*

[40] N.D. Rev. Code § 31-0403 (1943).

[41] Cf. U.C.C. § 3-117 and N.I.L. § 41.

[42] Dunham v. Peterson, 5 N.D. 414, 67 N.W. 293 (1896). The indorsement in that case read: "For value received, I hereby guarantee the within note, waiving notice or protest and demand." The remarks of Corliss J., are enlightening: "On the other hand it is elementary that the indorser may enlarge his liability without destroying the right of his indorsee to protection as an innocent purchaser. By waiving demand and notice, he changes a conditional liability into an absolute one. Yet, although such a waiver is made, the indorsee can claim the same exemption from the interposition of defenses to the paper that he could have claimed had there been no waiver. It is therefore apparent that the inquiry whether one is an indorsee of negotiable paper does not depend upon the question whether the person negotiating it has incurred the precise obligation of an indorser. He may incur more liability, or less liability, or no liability at all; and yet the purchaser may be an indorsee, and protected as such. Nor is the form of the indorsement material. It is an indorsement, although it is in terms an assignment." 5 N.D. 414, 417-18, 67 N.W. 293, 294. Cf. Britton, Bills and Notes § 58, p. 230 *et seq.* (1943).

[43] N.D. Rev. Code § 41-0414 (1943).

[44] U.C.C. § 3-203. "Where an instrument is made payable to a person under a misspelled name or one other than his own he may indorse in that name or his own or both; but signature in both names may be required by a person paying or giving value for the instrument."

SPECIAL INDORSEMENT; BLANK INDORSEMENT.

Section 3-204[45] of the Code covers material found in § 9 (5),[46] 33,[47] 34,[48] 35,[49] and 40[50] of the N.I.L. The important change to be noted here is the omission of § 35, and the introduction of the idea that the holder of paper has a right to indorse specially, altho the paper is bearer on its face.

Consider first the omission. Section 35 of the N.I.L. gave the holder power to "convert a blank indorsement into a special indorsement by writing over the signature of the indorser in blank any contract consistent with the character of the indorsement."[51] In practice the rule against material alterations limited this special privilege to one type of case—a holder under a blank indorsement by a prior party, could write in the name of a purchaser as special indorsee without signing his own name. Under the Code this is still possible, but the drafters thought that Section 35 might be confusing and an inducement to attempted alterations that are not authorized—as writing in "payment guaranteed" or "protest waived"—clearly material alterations of the indorser's contract.[52] The omission does not destroy existing rights of any importance. It still remains true that one may indorse without recourse, and if he is an agent, disclaim all liability. He may still write in the name of a special indorsee over a blank indorsement without signing his own name.

The second important change is the reversal of the rule found in § 40 of the N.I.L. that "Where an instrument, payable to bearer, is indorsed specially, it may nevertheless be further negotiated by delivery . . ."[53] A suggested reason for the rule, adopted in the N.I.L. from the common law, was that the contract of the promisor was to pay the bearer, and to hold that a special indorsement controlled would alter that contract

[45] U.C.C. § 3-204. "(1) A special indorsement specifies the person to whom or to whose order it makes the instrument payable. Any instrument specially indorsed becomes payable to the order of the special indorsee and may be further negotiated only by his indorsement.
(2) An indorsement in blank specifies no particular indorsee and may consist of a mere signature. An instrument payable to order and indorsed in blank becomes payable to bearer and may be negotiated by delivery alone until specially indorsed or indorsed for collection."

[46] N.D. Rev. Code § 41-0209 (5) (1943).

[47] N.D. Rev. Code § 41-0404 (1943).

[48] N.D. Rev. Code § 41-0405 (1943).

[49] N.D. Rev. Code § 41-0406 (1943).

[50] N.D. Rev. Code § 41-0411 (1943).

[51] Note 45, *supra*. The language of the code applies to "any instrument specially indorsed."

[52] Sawyer State Bank v. Sutherland, 36 N.D. 493, 162 N.W. 696 (1917).

[53] Note 50, *supra*.

and throw the risk of forgery upon him—a risk he did not assume under his contract.[54]

However, the drafters of the Code felt that the rights of the holder overbalanced the risk to the maker or drawer. The holder under the code now has the right to control who shall be entitled to receive payment by naming a special indorsee, and his indorsement is required as evidence of the satisfaction of the obligation. Since the law as to order instruments is that a blank indorsement makes the instrument payable to bearer, and such an indorsement can again be converted into a special, or by a subsequent special indorsement, the contract again becomes a promise to pay to order, the change is not as serious in practice as would appear at first blush. Certainly a practice exists in business circles of asking for the indorsement of the holder of bearer paper before purchase, and if the indorsement is special it would not be consistent with sound practice to take the instrument without requiring the indorsement of the special indorsee. On the whole the change does not seem unreasonable.[55]

CONDITIONAL INDORSEMENT PROHIBITING TRANSFER.

Section 3-205[56] of the Code covers the material governed by §39[57] of the N.I.L., and dissects Section 37,[58] by putting a new construction on an indorsement which prohibits further negotiation of the instrument under subdivision (1) of that section. It is here that we find an important departure from familiar law. The Code abolishes the term "restrictive" for reasons to be set out later; and this section converts one type of restrictive indorsement into a conditional indorsement.

We do not have too many examples of a true conditional indorsement.[59] At common law a conditional indorsement was a trap for the unwary. Such an indorsement not only limited the right of the conditional indorsee to proceed against the conditional indorser,[59a] but also made it impossible for the

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[54] Britton, Bills and Notes 245-46 (1943).

[55] Another change here extends the indorser's liability to a remote holder. Under Section 40, a subsequent holder could not sue unless he took by indorsement from the special indorsee. U.C.C. § 3-417 (2).

[56] U.C.C. § 3-205. "Neither a conditional indorsement nor one purporting to prohibit further transfer of the instrument prevents its further transfer or negotiation, and the transferee may enforce payment in disregard of the limitation; but the indorsee and any other subsequent transferee except a collecting or payor bank takes the instrument or its proceeds subject to any rights of the indorser."

[57] N.D. Rev. Code § 41-0410 (1943).

[58] N.D. Rev. Code § 41-0407 (1943).

[59] See Smith v. Shaw, 16 N.D. 306, 112 N.W. 1062 (1907).

[59a] Randles v. Gully, 128 Okla. 220, 262 Pac. 201 (1927).

payor safely to pay the holder at maturity[59b]—since the payor ran the risk that the condition might not have been fulfilled. The drafters of the negotiable instruments law felt this to be unreasonable[60]—hence § 39 changed the common law giving the payor the protection he needed—the right to pay the bill regardless of the condition. Thus the holder alone remained responsible to the indorser for the fulfilment of the condition.

This section, then, retains the substance of § 39, as to the effect of a conditional indorsement, and adds a new element—under the Code an indorsement that purports to prohibit further transfer of the instrument is to be construed as conditional. It loses its effect so far as its prohibitory force is concerned, and is to be construed as an ordinary conditional indorsement. Thus, "Pay A only" is to be construed as if it read, "Pay A on condition he does not transfer."[61] Obviously, anyone purchasing an instrument with such an indorsement cannot take as a holder in due course.[62] The statute, however, makes one exception to this. In recognition of the fact that the indorser contemplates further transfer of the instrument for the purpose of collection, the effect of an indorsement "pay A only" as notice of the rights of the indorser, is cut off when the instrument passes into the hands of a bank or group of banks for the purpose of collection. Incidentally, such an indorsement does not have the effect of an indorsement for collection or deposit. There the customer's bank—the depositary bank—is on notice that the purpose of the indorsement was to create an agency for collection. Subsequent banks under such an indorsement should be holders in due course, in a proper case, since the instrument came to them through collection channels, and not from a private holder.[63] Under this section of the Code the depositary bank also may become a holder in due course because the indorsement "pay A only" no longer is treated as restrictive.

[59b] Robertson v. Kensington, 4 Taunt. 30 (1811).

[60] "Commissioners' Note: The first sentence is the same as Section 33 of the Bills of Exchange Act with a slight modification. In his note to that section Judge Chalmers says: 'This section alters the law. It was formerly that if a bill was indorsed conditionally, the acceptor paid it at his peril if the condition was not fulfilled. This was hard on him. If he dishonored the bill he might be liable to damages, and yet it might be impossible for him to find out if the conditions had been fulfilled . . .' Beutel's Brannan Negotiable Instruments Law 25 (6th ed. 1938).

[61] The meaning of N.I.L. § 36 (1) is not clear. Section 37 (3) provides: "A restrictive indorsement confers upon the indorsee the right: . . . (3) to transfer his rights as such indorsee, where the form of the indorsement authorizes him to do so." The implication is that some forms of indorsement might restrict further transfer. The cases give no satisfactory answer. See Power v. Finnie, 4 Call. 411 (Va.1797); Rive v. Stearns, 3 Mass 225, 3 Am.Dec. 129 (1807).

[62] Note 56, *supra*.

[63] Discussed in the next section. See Note 64, *infra*.

Because of the obscurity surrounding this form of indorsement, the solution offered here seems logical and workable. The net effect is that a subsequent taker becomes a holder, but not in due course unless the instrument is in the collection process.

INDORSEMENT "FOR COLLECTION", "FOR DEPOSIT", TO AGENT OR IN TRUST[64]

This section of the Code deals with a narrow but confused area in transfers of commercial paper. It combines the material found in §§ 36[65] and 37[66] and omits § 47[67] of the N.I.L. Section 36 of the N.I.L. provides:

> "An indorsement is restrictive, which either:
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> (1) Prohibits further negotiation of the instrument or
>
> (2) Constitutes the indorsee the agent of the indorser; or
>
> (3) Vests the title in the indorsee in trust for or to the use of some other person . . ."

Section 36 (1) is illustrated by the form "Pay A Only"; § 36 (2) by the form, "Pay A for collection or remittance", or "Pay A for my account," etc. It differs from § 36 (1) in that it does not purport to prevent further transfer of the instrument, and creates an agency relationship. Section 36 (3), "Pay A for the use of X, or in trust for X", differs from (1) and (2) by naming a special indorsee who takes title for the benefit of some person other than the indorser or indorsee.

Section 36 (1) is treated as a conditional indorsement

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[64] U.C.C. § 3-206. "When an indorsement, whether blank or special, states that it is 'for collection', 'for deposit', or otherwise for the benefit or account or use of the indorser or of another person:
(a) the first taker under that indorsement must apply any value given by him for or on the security of the instrument in the manner and to the person or account directed by the indorsement;
(b) to the extent that he does so he becomes a holder for value;
(c) later holders for value are not affected by the direction contained in the indorsement unless they have reasonable grounds to believe that a fiduciary has negotiated the instrument in breach of duty. . ."

[65] N.D. Rev. Code § 41-0407 (1943).

[66] N.D. Rev. Code § 41-0408 (1943): "A restrictive indorsement confers upon the indorsee the right:
1. To receive payment of the instrument;
2. To bring any action thereon that the endorser could bring;
3. To transfer his rights as such endorsee, where the form of the endorsement authorizes him to do so.
But all subsequent endorsees acquire only the title of the first endorsee under the restrictive endorsement."

[67] N.D. Rev. Code § 41-0408 (1943): "An instrument negotiable in its origin continues to be negotiable until it has been restrictively endorsed under the restrictive endorsement."

under the Code as explained in the preceding section of this article. It seems axiomatic that § 36 (2) requires that the agency relationship be express.[68] Thus it is possible to hold that an indorsement in blank followed by the words "for deposit" would not be restrictive.[69] The words are ambiguous and although A's purpose may be to create an agency, the language itself does not indicate this. If agency exists it must be shown by parol, and that seems inconsistent with other provisions of the N.I.L. intended to prevent variation of the written contract by parol evidence. It is entirely consistent with the N.I.L. to call this an unqualified indorsement, and give subsequent holders the status of due course holders. Yet this is a common form of indorsement utilized by business men in the vain hope that the depositary bank will be put on notice of the indorser's rights in the instrument. On the other hand, the indorsement "for collection" is generally conceded to be restrictive.[70] Recognizing that § 36 of the N.I.L. does not fully coincide with business practice the Code now expressly provides that an indorsement followed by the words "For Deposit", or "For Collection" will put the first taker on notice and prevent him from assuming the status of a due course holder until he has remitted for the instrument.

The second aspect of this problem involves the rights of subsequent holders. While we might agree that the indorsement in blank, followed by the words "For Deposit", or "For Collection" would put one who received the instrument from the indorser on notice that this constituted an agency for collection, if the agent advanced to the indorser the full value in cash, it must be conceded that he stands in the shoes of the indorser and if the latter is a holder in due course he can enforce the instrument free of defenses of the maker.[71] Is

[68] Britton, Bills and Notes 268 *et seq.* (1943).

[69] Security Bank of Minnesota v. Northwestern Fuel Co., 58 Minn. 141, 59 N.W. 987 (1894). One possible explanation of the words "For deposit only in X bank" is to indicate to the bank that the agent of the depositor has only limited power to deal with the instrument. Banks themselves no longer use this form, having substituted the words "Pay any Bank or Banker, prior indorsements guaranteed." This form was held non-restrictive in a North Dakota decision, First National Bank of Minneapolis v. Wells County, 54 N.D. 502, 209 N.W. 962 (1926). The authorities are divided as to both forms of indorsement. See Britton, *op cit. supra* note 68, at 268, n.l; 270, n.3.

[70] The word "collection" implies an agency for that purpose. See form of indorsement in State v. Hanson, 55 N.D. 370, 213 N.W. 353 (1926).

[71] In Continental National Bank & Trust Co. v. Stirling, 65 Ida. 123, 140 P.2d 230 (1943), it was held that where the drawer-payee indorsed an accepted trade acceptance restrictively, and then sold the instrument to a bank, the latter became a holder in due course on the theory that the indorser had waived the restriction. In State v. Hanson, *supra* note 70, a similar result was reached by resorting to estoppel. Such circuitous reasoning results from holding that a restrictive indorsement destroys the negotiability of an instrument.

there any good reason why he should not be a holder in due course regardless of the status of the indorser? If the instrument is dishonored in the hands of the indorsee is the indorser liable to him as an unqualified indorser? Under the doctrine of restrictive indorsement the answer must be no—the indorsement is qualified because the indorsee receives title in trust for collection and remittance, there is a string attached to the interest received by the indorsee. It follows that only for breach of the contract of agency, aside from the doctrine of negotiability, can the indorsee sue the indorser. There are many decisions under the N.I.L. to the effect that the instrument becomes a simple contract after restrictive indorsement[72] and apparently Section 47 of the N.I.L. bolsters that result by stating that an instrument remains negotiable until it has been restrictively indorsed.

This circumcision of the holder in due course principle is not compelled by business practice in the collection of commercial paper. Conditional credits are standard in the banking field, and it is reasonable that the collection agent should be given a lien to the extent that actual cash has been parted with, and to that extent the initial bank should be a holder in due course. The same holds true of later holders in the collection process. The form of the indorsement makes them aware of an agency but it is not notice to them that a breach of that relationship has already occurred.[73] The Code reverses some bad law in this area and coincides more closely with the fundamental doctrine of holder in due course, and it accomplishes this result by abandoning the term "restrictive" and omitting § 47.

The third form of indorsement under § 36 caused difficulty where the rights of subsequent holders were involved. Some courts applied § 47 literally and held that no holder could become a holder in due course in such a case.[74] The mere fact that the indorsement is in trust for a third person does not make the indorsement and transfer to the indorsee qualified. The rights have now passed to the beneficiary and no strings are retained by the indorser in this case. The better view under the N.I.L., therefore, held that the first indorsee might become a holder in due course.[75] The Code abandons the clumsy

[72] 8 Am.Jur., Bills and Notes § 545; 10 C.J.S., Bills and Notes § 214 (c).

[73] "The purchaser has notice of a claim against the instrument when he has reasonable grounds to believe:
(b) that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty." U.C.C. § 3-304 (2).

[74] Gulbranson-Dickinson Co. v. Hopkins, 170 Wis. 326, 175 N.W. 93 (1919).

[75] Atlantic City National Bank v. Commercial Lumber Co., 107 N.J.L. 492, 155 Atl. 762 (1931) (apparently based on estoppel).

language of § 37 to the effect that "all subsequent indorsees acquire only the title of the first indorsee under the restrictive indorsement."

In conclusion, this section of the Code enlarges the holder in due course principle to encompass the field formerly covered by the sections of the N.I.L. dealing with restrictive indorsements. In so doing it has attempted to harmonize business practice in commercial collections with the due course principle. The net result is that large areas of disagreement in the case law have been wiped out and we can make a fresh start. There are no longer three different types of indorsement to deal with, but one type which may take several forms, with a single principle to govern. Since the collection field today is largely governed by contract or by special statute, a restrictive form of indorsement that limited negotiability is no longer needed, and the drafters wisely recognized this fact.

NEGOTIATION EFFECTIVE ALTHOUGH IT MAY BE RESCINDED.

Section 3-207[76] of the Code extends the principle of § 22[77] of the N.I.L. to all types of voidable transfers. Section 22 provides:

> "The indorsement or assignment of the instrument by a corporation or by an infant passes the property therein, notwithstanding that from want of capacity the corporation or infant may incur no liability thereon."

In short, this section of the code continues the policy of extending the holder in due course principle. Since it is familiar law that even a thief may pass on an instrument indorsed in blank, there is nothing inconsistent in holding that indorsements voidable for lack of capacity to contract,[78] fraud,[79] duress, mistake, or breach of trust[80] are sufficient to pass title and will make the instrument enforceable by a holder in due course against all parties except one having a

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[76] U.C.C. § 3-207. "(1) Negotiation is effective to transfer the instrument although the negotiation is:
(a) made by an infant, a corporation exceeding its powers, or by any other person without capacity; or
(b) obtained by fraud, duress, or mistake of any kind; or
(c) made in breach of duty.
(2) Except as against a subsequent holder in due course such negotiation is subject to rescission, the declaration of a constructive trust, or any other remedy permitted by law."

[77] N.D. Rev. Code § 41-0222 (1943).

[78] Nat. Bank of Commere v. Pick, 13 N.D. 74, 99 N.W. 63 (1904).

[79] Drinkall v. Movious State Bank, 11 N.D. 10, 88 N.W. 724 (1901) (apparently inconsistent with theory set out above).

[80] Baird v. Lorenz, 57 N.D. 804, 224 N.W. 206 (1929).

real defense under state law. As is the case under existing law, the Code does not purport to determine which defenses are real and which are personal. Subsection (2) of § 3-207 provides:

> "Except as against a subsequent holder in due course such negotiation is subject to recission, the declaration of a constructive trust or any other remedy permitted by law."

Under this section then, the indorsement and transfer, altho void or voidable, passes title to the holder. If the indorser has a right of recission he resorts to available remedies under the general law of the state. This does not represent a new policy.

As to the holder in due course, it seems clear that the maker of a note cannot rely on a right of recission existing in favor of a subsequent holder to shift the burden of proof *on the holder in due course issue* to the shoulders of the plaintiff. The rule is the same under the N.I.L. The last sentence in §59[81] of the N.I.L. provides: "But the last-mentioned rule does not apply in favor of a party who became bound on the instrument prior to the acquisition of such defective title." To illustrate: if M issues his promissory note to P, and X secures possession and fraudulently negotiates to Y, X's fraud does not affect M, and therefore is not available to M as a defense when Y brings suit on the instrument. This situation, of course, must be distinguished from the case where the fraud was practised on M personally.[82] Sections 60,[83] 61,[84] and 62[85] of the N.I.L. have a direct bearing on this question so far as defenses available to the payee are concerned. Under those sections, the maker, drawer, and acceptor respectively admit the existence of the payee and his capacity to indorse. These sections read in conjunction with §§ 59 and 22 would seem to indicate a statutory policy which requires each party to assert his own defenses; but both before and after general adoption of the N.I.L. in this country the cases were in conflict as to the right of the maker to set up a defense available to a subsequent party.[86] The Code adopts the view that the maker can set up only his own defenses: "Unless he has the rights of a holder in due course any person takes the instrument subject to (d) the defense that he or a person through whom he holds the

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[81] N.D. Rev. Code § 41-0509 (1943).
[82] *But see* Drinkall v. Movious State Bank, 11 N.D. 10, 88 N.W. 724 (1901), and compare cases cited in notes 78 and 80, *supra*.
[83] N.D. Rev. Code § 41-0601 (1943).
[84] N.D. Rev. Code § 41-0602 (1943).
[85] N.D. Rev. Code § 41-0603 (1943).
[86] Britton, Bills and Notes § 160, p. 759 *et seq.* (1943).

instrument acquired it by theft. The claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon unless the third person himself defends the action for such party."[87]

In conclusion, this section completely revises sections 22 and 59 of the N.I.L. The purpose was to make it clear that in any case where the paper by its terms runs to a particular person, that person may pass the title on, although his own title is void or voidable. The section has no application in the case of a theft, because negotiation always includes delivery, and delivery is lacking in the theft cases. The section imposes no liability on the party negotiating, he may assert the defenses available to him if any exist; but remedies available to the indorser are cut off by transfer to a holder in due course. Here again, the results sought under the Code seem consistent with case law, although exceptions exist.

REACQUISITION

The concluding[88] section under Part Two of Article Three deals with the problems raised by §§ 48,[89] 50,[90] and 121[91] of the N.I.L. Apparently no change in existing law is intended, and simplification of the law has been achieved by the proposed revision.

It is beyond the scope of this paper to discuss the many legal problems raised by §§ 48, 50 and 121 of the N.I.L., but a brief survey will be attempted. Section 48 of the N.I.L. permits the holder at any time to strike out indorsements not necessary to his title and relieves from liability on the instrument the indorser whose name is stricken and all parties subsequent to him. The section further provides that "he is not entitled to enforce payment thereof against any intervening party to whom he is personally liable." This section is founded on the basic principle that one cannot deny his own warranties. To illustrate: if a prior party brings suit on an instrument on which the indorsements of A, B, and C appear after the holder's indorsement, these indorsements are not necessary to his title and may be stricken by him, and since his liability runs to them, whether stricken or not, he could not sue A, B or C.

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[87] U.C.C. § 3-306.

[88] U.C.C. § 3-208: "Where an instrument is returned to or reacquired by a prior party he may cancel any indorsement which is not necessary to his title and reissue or further negotiate the instrument, but any intervening party is discharged as against the reacquiring party and subsequent holders not in due course and if his indorsement has been cancelled is discharged as against subsequent holders in due course as well."

[89] N.D. Rev. Code § 41-0419 (1943).

[90] N.D. Rev. Code § 41-0421 (1943).

[91] N.D. Rev. Code § 41-0903 (1943).

Section 50 gives an additional right to the prior party who comes into possession of the instrument—he may reissue it. This he can do without striking prior indorsements—but whether he strikes them or not, the re-acquiring party cannot go against indorsers who signed after he did since his liability runs to these signers. The act is silent as to the rights of the transferor.

One might wonder why the N.I.L. contains another section, § 121, dealing with this problem. This section speaks of "payment" of the instrument by a secondary party. "Payment" is treated in § 88[92] of the N.I.L. as follows:

> "Payment is made in due course when it is made at or after the maturity of the instrument to the holder thereof in good faith and without notice that his title is defective."

Since the effect of payment by a primary party is to discharge the instrument,[93] this section was added to make it clear that where secondary parties were compelled to take up the instrument *at or after maturity* it was not discharged. It might be noted here that the Code no longer requires that payment be made in due course,[94] a point to be developed later, and thus one logical basis for drawing a line between acquisitions *of the instrument* by prior parties disappeared. By the elimination of the word "negotiate" in § 50 and the word "payment" used in § 121 it became possible to combine the sections without change in meaning. The use of the word "negotiate" in this section of the Code would be objectionable because it is inconsistent with actual business practice. Where a prior indorser is compelled to take up an instrument because of the default of the primary obligor there is no good reason why the holder should indorse before retransfer. In fact his signature in such a case would be merely an acknowledgment of receipt of payment. A broader term than "negotiate" is necessary and the Code takes cognizance of this by using the phrase "returned to or reacquired by a prior party."[95]

Another variation between §§ 50 and 121 is of interest. Section 121 speaks of reacquisition by a "secondary party",

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[92] N.D. Rev. Code § 41-0718 (1943).

[93] N.I.L. § 119 (1) (5): "A negotiable instrument is discharged:
(1) By payment in due course by or on behalf of the principal debtor;
(5) When the principal *debtor becomes the holder of the instrument at or after maturity in his own right.*" (Emphasis supplied).

[94] U.C.C. § 3-603 (1): "The liability of any party is discharged to the extent of his payment or satisfaction to the holder even though it is made with knowledge of a claim of another person to the instrument unless prior to such payment or satisfaction the person making the claim either supplies indemnity deemed adequate by the party seeking the discharge or enjoins payment or satisfaction by order of a court of competent jurisdiction in an action in which the adverse claimant and the holder are parties."

[95] See note 88, *supra*.

whereas section 50 uses the term "prior party", which of course is a much broader term and would include the primary obligor. The Code adopts the latter term, and hence one question that arises in any comparison with the N.I.L. involves the rights of a reacquiring primary party such as the maker of a note. Under the N.I.L. a line was drawn between the effect of "payment" before or after maturity. Where the instrument is paid after maturity by the principal debtor, it is discharged and all secondary parties are relieved of liability.[96] But payment by the principal debtor prior to maturity does not discharge the instrument as to a holder in due course.[97] Since the Code discharges all intervening secondary parties unless the taker is a holder in due course, the result is the same. Where the instrument is overdue in the hands of the primary party and this fact is evident on the face of the paper there can be no subsequent holder in due course and all intervening indorsers are discharged.

Section 121 of the N.I.L. makes two exceptions to the rule that an instrument may be reissued by a reacquiring secondary party:

> "(1) Where it is payable to the order of a third person, and has been paid by the drawer; and
> (2) Where it was made or accepted for accommodation, and has been paid by the party accommodated."

Since the section begins by stating that the instrument is not discharged *except* in these two instances, the natural inference is that where the drawer or the party accommodated takes up the instrument it is discharged. Hence it would be possible to hold that where an acceptor dishonored a trade acceptance and the drawer was held on his contract, he could not recover on the instrument against the acceptor because it had been discharged. Fortunately the courts have not accepted this view and the Code no longer speaks of discharge of the instrument in this connection—parties, not the instrument, are discharged.

The position of the reacquiring accommodation party is not too clear under the language of § 121. That section states

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[96] Note 93, *supra*. "A person secondarily liable on the instrument is discharged: (1) By any act which discharges the instrument. . ." N.I.L. § 120.

[97] An "on or before" note is discharged when taken up by the maker prior to the ultimate due date, Peltier v. McFerson, 67 Colo. 505, 186 Pac. 524 (1920), but there is ample authority that acquisition by the maker prior to maturity does not prevent reissuance by him. Citizens' National Bank v. Loranger, 163 La. 868, 113 So. 129 (1927). *Cf.* Mueller v. Jagerson Fuel Co., 203 Wis. 453, 233 N.W. 633 (1930).

that the reacquiring secondary party is "remitted to his former rights"; but since an accommodation party lends his name to add currency to the instrument it would appear that he neither has nor claims any prior right therein. The cases, therefore, have held that an accommodation party is entitled to sue the party accommodated, whether he signed as maker, drawer, drawee or indorser.[99] By abandoning the phrase, "remitted to his former rights", the Code escapes this necessity for strained construction of ambiguous language.

In conclusion, the rights of a purchaser from a reacquiring secondary party must be considered. It is arguable that the reacquiring party should have the right to leave the indorsements in full effect to give the paper greater marketability.[100] After all §§ 50 and 121 of the N.I.L. refer only to the rights of the reacquiring party—he cannot hold intervening indorsers because his warranties run to them. The N.I.L. does not say that a transferee of a prior party cannot proceed against intervening indorsers, whose names were not stricken. Would it be reasonable to assume that the re-acquirer should have the right to leave the indorsements in force to obtain a better market for his paper? Even if the transfer occurs after maturity the same arguments could be advanced. The Code appears to give a clear rule to govern this problem by providing that "any intervening party is discharged as against the reacquiring party and subsequent holders not in due course and if his indorsement has been cancelled is discharged against subsequent holders in due course as well." The Code adopts the theory that the rights of a subsequent transferee either before or after maturity cannot rise higher than the *known* rights of his transferor. This view accords with the common sense of the situation. A holder who takes with notice that secondary parties are discharged as to his transferor is not in a position to complain.[101]

(To Be Continued)——

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[98] Cuesta, Rey & Co. v. Newson, 102 Fla. 853, 136 So. 551 (1931).

[99] Lill v. Gleason, 92 Kan. 754, 142 Pac. 287 (1915). *Cf.* as to rights of surety co-maker to sue principal debtor, O'Neal v. Stuart, 281 Fed. 715 (6th Cir. 1922); Fox v. Kroeger, 119 Tex. 511, 35 S.W.2d 679 (1931).

[100] Chafee, *Reacquisition of a Negotiable Instrument by a Prior Party*, 21 Col.L.Rev. 538 (1921).

[101] State Finance Corp. v. Pisterino, 245 Mass. 402, 139 N.E. 653 (1923), would not be good law under the code. The fact that the instrument was in the hands of a prior party should have put the purchaser on notice that intervening indorsers were discharged. Cf. U.C.C. § 3-305 (2) (e): "To the extent that a holder is a holder in due course he takes the instrument free from: . . .
(2) all defenses of any party to the instrument with whom the holder has not dealt except . . .
(e) any other discharge of which the holder has notice when he takes the instrument."

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