PAYMENT SYSTEMS
ELECTRONIC CASEBOOK

CHAPTER 3—CHECKS
SECTIONS 3, 4, AND 5

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checks were processed by computers in the normal manner, they would cause a second (duplicate) deduction from the depositor’s account when presented for payment.

Although certification largely has fallen into desuetude, the concept of “acceptance” remains important, as we shall see when we consider banker’s acceptance and trade acceptances.

(3) Cashier’s Checks. Like certified checks, cashier’s checks represent the obligation of the bank. This obligation is identical to that of the maker of a note. See UCC 3–412; Chapter 1, Section 2, supra. A cashier’s check (or official check) is a draft as to which the drawer and drawee are the same bank or branches of the same bank. See UCC 3–104(g). Unlike certified checks, cashier’s checks flow smoothly and normally through computerized systems.

SECTION 3. PAYOR BANK’S LIABILITY ON PAYMENT

(A) PAYMENT BY PASSAGE OF THE MIDNIGHT DEADLINE

The rule of UCC 3–409 may be a perfectly good way to resolve certain kinds of conflicts (or it may not be), but it would be impossible to run the check-collection system on this basis. Inasmuch as the payor bank has no obligation to the payee or subsequent person entitled to enforce the instrument, neither the payee nor its bank would know whether the check had been paid or dishonored. Of course, the law might require the payor bank to notify the payee or its bank upon payment, or authorize interested persons to make a direct inquiry to the payor bank. The only problem would be that each check would then be somewhere between ten and one thousand times more expensive to process than it is at present.

The law solves this problem by, first, requiring that a payor bank settle for an item on the day of receipt, and, second, providing that a check is paid after the mere passage of time. Even though Reg CC 229.36(d) provides that “[s]ettlements between banks for the forward collection of a check are final when made,” on dishonor a payor bank may recover the amount of a settlement from a bank to which the check is returned. Although the payor bank retains the right to dishonor the check and recover the amount of its settlement, it must take positive action to do so, and this action must be taken before the time limit expires. Making payment the presumption and placing the burden on dishonor is sensible because the overwhelming majority of checks are paid. Thus, the amount of information that must flow through the system, and the resulting costs of check processing, is held to a minimum.

As with comedy, so with dishonor: timing is critical to success. Since the depositary bank does not receive notification of payment, it can determine
that a particular check is good, i.e., that the check has been paid by the payor bank, only by waiting until the time during which it might have been informed of dishonor has elapsed. The longer the dishonor process takes, the longer the depositary bank must wait before it can be certain that the check is good and that the bank will be not obligated to disgorge the settlement it received for the check. The longer the depositary bank must wait, the longer the bank will make its customer wait before releasing the funds represented by the deposited check.

UCC 4–301(a)(3) and (d) permits a payor bank that wishes to dishonor an item to revoke and recover the settlement it gave for the item, provided that the bank physically returns (i.e., sends or delivers) the item before the expiration of the bank’s midnight deadline. The midnight deadline is “midnight on [the bank’s] next banking day on which it receives the relevant item.” UCC 4–104(a)(10). Clearing house rules, which are effective to vary the effect of Article 4’s provisions, see UCC 4–103(a), (b), often shorten this period of time. Failure to return the item in a timely fashion results in “final payment.” UCC 4–215(a)(3). Although UCC 4–301(d) provides that a dishonored check should be returned to the bank’s customer or transferor or, in appropriate cases, to the clearing house, Regulation CC authorizes payor banks to return a dishonored item to the depositary bank or to any other bank agreeing to handle the check expeditiously. Reg CC 229.30(a).

Problem 2.3.1. Empire’s account has only $10,000 in it. On Wednesday, The Bank of New York receives the check payable to Quaker from the Federal Reserve Bank of Philadelphia, to which PNC Bank had sent it for collection. The Bank of New York mislays the check for two days and on Friday, when the check is put through the regular computer run, it is rejected as drawn on insufficient funds.

(a) What are The Bank of New York’s rights against Quaker? See UCC 4–215; UCC 4–301; Reg CC 229.30(c)(1).

(b) How would it affect your answer if the check were presented through The Clearing House?

NOTES ON THE MIDNIGHT DEADLINE

(1) Deferred Posting. The Court of Appeals of Kentucky provided the following explanation of the history of the payor bank’s liability for retaining a check that was presented for payment:

Under the Uniform Negotiable Instruments Law a payor bank was not liable to the holder of a check drawn on the bank until the bank had accepted or certified the check. Because of the payor bank’s basic nonliability on a check, it was essential that some time limit be placed upon the right of the payor bank to dishonor a check when presented for payment. If a payor bank could hold a check indefinitely without incurring liability, the entire process of collection and payment of checks
would be intolerably slow. To avoid this problem, a majority of courts construing § 136 and § 137 of the Uniform Negotiable Instruments Law held that a payor bank was deemed to have accepted a check if it held the check for 24 hours after the check was presented for payment. Thus, in a majority of jurisdictions, the payor bank had only 24 hours to determine whether to pay a check or return it. However, in . . . a few . . . jurisdictions, the courts held that § 136 and § 137 of the Uniform Negotiable Instruments Law applied only to checks which were presented for acceptance [i.e., certification]. In Kentucky Title Savings Bank and Trust Company v. Dunavan, 205 Ky. 801, 266 S.W. 667 (1924), the Court of Appeals held that § 136 and § 137 of the Uniform Negotiable Instruments Law had no application to a check which was presented for payment. Consequently, the payor bank would be liable on the check only if it held the check “for an unreasonable length of time” and could thus be deemed to have converted the check.

In order to bring uniformity to the check collection process, the Bank Collection Code was proposed [in 1929] by the American Bankers’ Association. [By 1932, 18 states had adopted it.] Under § 3 of the Bank Collection Code, a payor bank could give provisional credit when a check was received, and the credit could be revoked at any time before the end of that business day. The payor bank became liable on the check if it retained the item beyond the end of the business day received.

Banks had only a few hours to determine whether a check should be returned because of insufficient funds. Banks were required to “dribble post checks” by sorting and sending the checks to the appropriate bookkeepers as the checks were received. This led to an uneven workload during the course of a business day. At times, the bookkeeping personnel might have nothing to do while at other times they would be required to process a very large number of checks in a very short time. Because of the increasingly large number of checks processed each day and the shortage of qualified bank personnel during World War II, it became impossible for banks to determine whether a check was “good” in only 24 hours. The banks were forced to resort to the procedure of “paying” for a check on the day it was presented without posting it to the customer’s account until the following day. To meet this situation, the American Banking Association proposed a Model Deferred Posting Statute.

Under the Model Deferred Posting Statute, a payor bank could give provisional credit for a check on the business day it was received, and the credit could be revoked at any time before midnight of the bank’s next business day following receipt. A provisional credit was revoked “by returning the item, or if the item is held for protest or at the time is lost or is not in the possession of the bank, by giving written notice of dishonor, nonpayment, or revocation; provided that such item or notice
is dispatched in the mails or by other expeditious means not later than midnight of the bank’s next business day after the item was received.” If the payor bank failed to take advantage of the provisions of the deferred posting statute by revoking the provisional credit and returning the check within the time and in the manner provided by the act, the payor bank was deemed to have paid the check and was liable thereon to the holder.

The Model Deferred Posting Statute was the basis for the provisions of the Uniform Commercial Code. Under § 4–301(1) of the Uniform Commercial Code (UCC), a payor bank may revoke a provisional “settlement” if it does so before its “midnight deadline” which is midnight of the next banking day following the banking day on which it received the check. Under the Model Deferred Posting Statute, the payor bank’s liability for failing to meet its midnight deadline was to be inferred rather than being spelled out in the statute. Under UCC § 4–302, the payor bank’s liability for missing its midnight deadline is explicit. If the payor bank misses its midnight deadline, the bank is “accountable” for the face amount of the check.

Like the Model Deferred Posting Statute, the Uniform Commercial Code seeks to decrease, rather than increase, the risk of liability to payor banks. By permitting deferred posting, the Uniform Commercial Code extends the time within which a payor bank must determine whether it will pay a check drawn on the bank. Unlike the Bank Collection Code or the Uniform Negotiable Instruments Law as construed by most courts, the Uniform Commercial Code does not require the payor bank to act on the day of receipt or within 24 hours of receipt of a check. The payor bank is granted until midnight of the next business day following the business day on which it received the check. Blake v. Woodford Bank & Trust Co., 555 S.W.2d 589, 594 (Ky. App. 1977) (citations omitted) (references are to the pre–1990 version of Article 4).

(2) When the Midnight Deadline Begins to Run. According to UCC 4–104(a)(10), the payor bank’s midnight deadline begins to run on “the banking day on which it receives the relevant item.” But UCC 4–108 allows the bank to “fix an afternoon hour of 2 P.M. or later as a cutoff hour for the handling of . . . items,” and an item “received on any day after a cutoff hour so fixed . . . may be treated as being received at the opening of the next banking day.”

Comment 1 to UCC 4–108 explains:

“Each of the huge volume of checks processed each day must go through a series of accounting procedures that consume time. Many banks have found it necessary to establish a cutoff hour to allow time for these procedures to be completed within the time limits imposed by Article 4. Subsection (a) approves a cutoff hour of this type provided it is not earlier than 2 P.M. Subsection (b) provides that if such a cutoff hour is
fixed, items received after the cutoff hour may be treated as being received at the opening of the next banking day. If the number of items received either through the mail or over the counter tends to taper off radically as the afternoon hours progress, a 2 P.M. cutoff hour does not involve a large portion of the items received but at the same time permits a bank using such a cutoff hour to leave its doors open later in the afternoon without forcing into the evening completion of its settling and proving process.

(3) Automation and the Midnight Deadline. A large bank typically operates its own data processing center serving all the bank's branches within a given geographic region. Smaller banks often use the processing center maintained by a large bank. Is the running of the period that determines the midnight deadline under UCC 4–301 triggered by the receipt of the check at the data processing center or by the subsequent receipt of the check by the payor bank?

Courts gave conflicting answers under the UCC. Thus in Idaho–Best v. First Security Bank, 99 Idaho 517, 584 P.2d 1242 (1978), the court held that the period was not triggered until receipt by the payor bank. But in Central Bank of Alabama v. Peoples National Bank, 401 So.2d 14 (Ala.1981), the Supreme Court of Alabama declined to apply Idah–Best, concluding that the computer was “an integral part” of the bank. To postpone the running of the period until receipt by the payor bank, the court reasoned, would “thwart the very purpose of the midnight deadline: to encourage prompt return of dishonored checks” and “would have the effect of allowing the payor bank to unilaterally decide when the midnight deadline would begin to run by the simple device of choosing the time to forward the check to the branch.”

Regulation CC 229.36(b)(1) takes this latter position. It adopts, as the Commentary to that section puts it, “the common-law rule of a number of legal decisions that the processing center acts as the agent of the paying bank to accept presentment and to begin the time for processing of the check.”

(4) Extension of the Midnight Deadline. Although Reg CC contains provisions to expedite the return of dishonored items, it contains two notable provisions that extend the deadline for return of an item. First, in most cases Reg CC extends the deadline for return of an item to the time the return is sent if a paying bank uses a means of delivery that would ordinarily result in receipt by the bank to which it is sent on or before the receiving bank's next banking day following the otherwise applicable deadline (i.e., in most cases, on the receiving bank's next banking day following the expiration of the midnight deadline) by the close of that banking day (or, if earlier, a cutoff hour of 2 p.m. or later set by the receiving bank under UCC 4–108). This deadline is extended further if a paying bank uses a highly expeditious means of transportation, even if this means of
transportation would ordinarily result in delivery after the receiving bank’s next cutoff hour or banking day. See Reg CC 229.30(c)(1).

Second, Reg CC 38(e) extends not only the midnight deadline but also other time limits within which a bank must act if a bank is delayed because of circumstances beyond its control and the bank exercises such diligence as the circumstances require. The time limit is extended for the time necessary to complete the action. UCC 4–109(b) [F4–108] is to a similar effect, but rather than extend the time to act, Article 4 excuses the delay.

The rules excusing delay by a payor bank seem to suggest a principle of moral culpability: If the event causing the delay is within the bank’s control (e.g., ill-trained bookkeepers), or if the bank fails to exercise such diligence as the circumstances require, then the bank should be responsible; but if the event is beyond the bank’s control (e.g., power outage), and the bank acts diligently, then the bank should be excused. This analysis presents two difficulties. First, if the loss does not fall on the bank, and the government does not step in, the loss necessarily falls on the depositor, who is not culpable at all. Second, the extent of the bank’s control is not fixed. There almost always is something the bank can do. It can provide for emergency power in the case of power outages (hospitals do this, and probably would be found criminally negligent if they did not); it could establish back-up systems for computer malfunction; it could keep a private jet at the processing center to deliver dishonored checks when transportation facilities fail.

(5) Underencoded Checks. Suppose that a bank receives for deposit a $255,000 check drawn on it, erroneously encodes the amount as $25,000, and credits the payee and charges the drawer in that amount. Months later, when the error is discovered, the drawer has closed its account and gone out of business. Is the bank liable to the payee for $230,000? That is what happened in SOS Oil Corp. v. Norstar Bank of Long Island, 76 N.Y.2d 561, 561 N.Y.S.2d 887, 563 N.E.2d 258 (1990). In an opinion by Judge Kaye, the court held for the payee.

The Uniform Commercial Code imposes distinct accountability on payor banks, providing in section 4–302 that: ‘In the absence of a valid defense such as breach of a presentment warranty (subsection [1] of Section 4–207), settlement effected or the like, if an item is presented on and received by a payor bank the bank is accountable for the amount of * * * a demand item other than a documentary draft whether properly payable or not if the bank, in any case where it is not also the depositary bank, retains the item beyond midnight of the banking day of receipt without settling for it or, regardless of whether it is also the depositary bank, does not pay or return the item or send notice of dishonor until after its midnight deadline’.

Absent certain defenses, a payor bank, even when also functioning as a depositary bank, may by the operation of UCC 4–302 be held
accountable to a payee for the amount of a check presented for immediate payment when it fails to pay, return or send notice of dishonor before the midnight deadline—that is, midnight of the next banking day following the banking day on which the bank receives the check. . . . A payor bank’s delay is thus tantamount to final payment of the item according to its tenor. . . . The statute makes the bank fully accountable whether it has paid nothing or—as here—something less than the face amount of the instrument. . . .

The midnight deadline rule of UCC 4–302 places a heavy burden on payor banks—one that exceeds that of depositary or collecting banks, which can reduce their obligation by the amount that could not have been recovered had ordinary care been used. . . . The heavy burden imposed by UCC 4–302 serves important commercial purposes: it expedites the collection process by motivating banks to process instruments quickly, and it firms up the provisional credits received by each bank in the collection chain, thereby supplying a key element of certainty in commercial paper transactions. . . . By requiring that deficiencies in a drawer’s account be determined swiftly, the midnight deadline rule is a vital part of the payor bank’s role in assuring the integrity of commercial paper. . . .

In the present case, it is undisputed that [the payee’s] check and deposit slip were in all respects regular and accurate, that the only actual mistake was [the bank’s], and that [the bank] retained the check past its midnight deadline. Under UCC 4–302, [the bank] is therefore accountable for the face amount of the check.

What difference, if any, would it have made if the balance in the drawer’s account had exceeded $230,000?

Suppose that the check had not been an on-us item and that it was the depositary bank that made the encoding error before forwarding the check to the payor bank. Is the payor bank liable to the payee for $230,000? If so, has the payor bank a claim against the depositary bank? See UCC 4–209 (discussed in Section 6(A), infra).

(6) Liability not “Absolute.” The payor bank’s liability under UCC 4–302 is not based on fault. Indeed, some case law under Former Article 4 asserted that the liability created by UCC 4–302 is “absolute” unless the payor bank can prove that its delay was excused. See, e.g., Engine Parts v. Citizens Bank of Clovis, 92 N.M. 37, 582 P.2d 809, 815 (1978). The 1990 revisions added subsection (b) to UCC 4–302. This provision gives a payor bank the defense “that the person seeking enforcement of the liability presented or transferred the item for the purpose of defrauding the payor bank.” Comment 3 explains: “Decisions that hold an accountable bank’s liability to be ‘absolute’ are rejected. A payor bank that makes a late return of an item should not be liable to a defrauder operating a check kiting scheme.”
Judge John F. Grady explained how check kiting works:

Check kiting is a form of bank fraud. The kiter opens accounts at two (or more) banks, writes checks on insufficient funds on one account, then covers the overdraft by depositing a check drawn on insufficient funds from the other account.

To illustrate the operation, suppose that the defrauder opens two accounts with a deposit of $500 each at the First National Bank and a distant Second National Bank. (A really successful defrauder will have numerous accounts in fictitious names at banks in widely separated states.) The defrauder then issues for goods or cash checks totalling $3000 against the First National Bank. But before they clear and overdraft the account, he covers the overdrafts with a check for $4,000 drawn on the Second National Bank. The process is repeated innumerable times until there is a constant float of worthless checks between the accounts and the defrauder has bilked the banks of a substantial sum of money.

John D. O’Malley, “Common Check Frauds and the Uniform Commercial Code,” 23 Rutgers L.Rev. 189, 194 n. 35 (1968-69). By timing the scheme correctly and repeating it over a period of time, the kiter can use the funds essentially as an interest-free loan.

Check kiting is possible because of a combination of two rules found in Article 4 of the Uniform Commercial Code. Under [UCC 4–210(a)(1); F4–208(a)(1)], a depositary bank may allow a customer to draw on uncollected funds, that is, checks that have been deposited but not yet paid. Second, under §§ 4–301 and 4–302, a payor bank must either pay or dishonor a check drawn on it by midnight of the second [sic] banking day following presentment. Thus when a kite is operating, the depositary bank allows the kiter to draw on uncollected funds based on a deposit of a check. The depositary bank presents that check to the payor bank, which must decide whether to pay or return the check before the midnight deadline. The check may appear to be covered by uncollected funds at the payor bank, and so the payor bank may decide to pay the check by allowing the midnight deadline to pass.

A kite crashes when one of the banks dishonors checks drawn on it and returns them to the other banks involved in the kite. Clark, supra. Usually, such a dishonor occurs when one bank suspects a kite. Id. However, an individual bank may have trouble detecting a check kiting scheme. “Until one has devoted a substantial amount of time examining not only one’s own account, but accounts at other banks, it may be impossible to know whether the customer is engaged in a legitimate movement of funds or illegitimate kiting.” James J. White & Robert S.
Summers, Uniform Commercial Code § 17–1 (3d ed. 1988 & Supp.1994). But each bank is usually able to monitor only its own account, and “[t]here is no certain test that distinguishes one who writes many checks on low balances from a check kiter.” White & Summers, supra, § 17–2. Even if a bank suspects a kite, it might decide not to take any action for a number of reasons. First, it may be liable to its customer for wrongfully dishonoring checks. [UCC 4–402]. Second, if it reports that a kite is operating and turns out to be wrong, it could find itself defending a defamation suit. White & Summers, supra, § 17–1 (Supp.1994). Finally, if it errs in returning checks or reporting a kite, it may risk angering a large customer. Id.


Interestingly, Judge Grady did not refer to UCC 4–302(b) when absolving the payor bank of liability in the First National Bank case. Instead, he followed other cases holding that, by attempting to shift the loss of a kite, a depositary bank does not act in bad faith so as to defeat its UCC 4–302 accountability claim. In his view, the two banks being defrauded, First National and Colonial, “were faced with the same dilemma at the same time: a number of checks totalling [sic] a goodly sum of money drawn on the account of a customer with low collected funds balances. First National chose to return the checks unpaid, but Colonial chose to trust its customer to cover the checks. By the time Colonial realized that its decision was wrong, it was too late—the midnight deadline had passed and the checks were paid. Each bank made a business decision; First National’s turned out to be the correct one.”

Do you agree with the preponderance of the case law that a bank has no good faith obligation to disclose a suspected kite or to refrain from attempting to shift the kite loss? Is a bank’s effort to shift the loss (i.e., by returning checks drawn on the bank while at the same time forwarding checks that have been deposited with it for payment) consistent with reasonable commercial standards of fair dealing? If not, what should the bank do to act in good faith?

For a case applying UCC 4–302(b) to a check-kiting scheme, see Bank of America NT & SA v. David W. Hubert, P.C., 153 Wash.2d 102, 101 P.3d 409 (2004). In that case, the court held that UCC 4–302(b) prevented the depositor from holding the payor bank accountable for missing the midnight deadline because the fraud of the depositor’s agent was imputed to the depositor.

**Problem 2.3.2.** Would your answer to Problem 2.3.1 be the same if the Empire check had already been presented and dishonored by insufficient funds and was being presented a second time when it was mislaid? See UCC
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4–302; David Graubart, Inc. v. Bank Leumi Trust Co., infra.; Notes on Represented Checks, infra.

**David Graubart, Inc. v. Bank Leumi Trust Co.**

Court of Appeals of New York, 1979.

Fuchsberg, Judge. On this appeal, here on a question certified by the Appellate Division pursuant to CPLR 5602 (subd. [b], par. 1), we are called upon to determine the role played by article 4 of the Uniform Commercial Code in fixing rights and obligations arising out of a second presentment of a check previously returned for insufficient funds. The heart issue is whether a payor bank is relieved of liability for retaining such an instrument beyond its “midnight deadline” (see Uniform Commercial Code, § 4–302) when it does so pursuant to an agreement concordant with a practice among banks for a payor to hold a previously dishonored item long enough to provide an opportunity for sufficient funds to be deposited by the drawer to meet the check.

The operative facts are uncomplicated. Plaintiff David Graubart, Inc. (payee), was issued a check for $13,000 drawn by the Prins Diamond Company on the latter's account with the defendant Bank Leumi Trust Company (payor bank). Graubart then deposited the check in its own account with the National Bank of North America (depositary bank), which, pursuing normal collection channels, routed it to the payor bank via the New York Clearing House. When the payor bank found that the Prins account had been overdrawn, it marked the item “insufficient funds” and promptly returned it to the depositary bank, again through clearing house channels. Notified of the dishonor, the payee redeposited the check with its bank, which this time apparently chose to forward it directly to Leumi on a collection basis, thus bypassing the clearing house (see [UCC 4–204(b)(2)]). The item was accompanied by an “advice to customer” slip—a copy of which was also delivered to Graubart—indicating, as with collection items generally, that credit would only be given on payment. In addition, in a space bearing the printed legend “Special Instruction: (Return immediately if not paid unless otherwise instructed)”, the slip contained a typed direction that the payor bank was to “remit [its] cashier’s [sic] check when paid”. But when, after no more than seven banking days, the drawer’s account remained bare of funds to permit the check to clear, Leumi again returned...

* [The case was decided under the applicable pre–1990 version of the UCC. Where appropriate, citations have been changed to refer to current version.]
the check to the depositary bank. Sometime during the course of these transactions the drawer made an assignment for the benefit of creditors.[*]

The gravamen of the fourth cause of action in the suit the payee thereafter commenced against Leumi, as well as of its subsequent motion for summary judgment, was that the latter's failure to return the resubmitted check to the depositary bank before its “midnight deadline”—defined as midnight of the next banking day following that on which the item was received—without more, rendered it liable to the payee for the face amount of the check under subdivision (a) of section 4–302 of the Uniform Commercial Code. This section, with seeming finality, provides, in pertinent part, that “if an item is presented on and received by a payor bank the bank is accountable for the amount of . . . a demand item . . . if the bank . . . retains the item beyond midnight of the bank[ing] day of receipt without settling for it or . . . does not pay or return the item or send notice of dishonor until after its midnight deadline.”

In opposition, and in support of its own cross motion, the payor bank submitted an affidavit by its assistant vice-president, who, after setting out his knowledge of banking practice, asserted that the “advice to customer” slip constituted a memorandum of an agreement requiring it to process the instrument in question in accordance with a common banking practice whereunder previously dishonored checks were to be held for such time as is reasonable under all the circumstances, even beyond the midnight deadline if necessary, to enable funds from which to pay them to come into the account. To this the payee’s only reply was in the form of counsel’s affirmation. Aside from a bald assertion, for which no foundation was supplied, challenging the existence of the custom, the affirmation merely interjected, for the first time, unsupported allegations of bad faith and collusion on Leumi’s part. Though it stated that the drawer was indebted to Leumi at the time of the assignment for the benefit of creditors, it made no showing of any unfair conduct on the part of the payor bank whatsoever.

Special Term denied both motions, holding that triable issues existed, and the Appellate Division, over a vigorous dissent by Mr. Justice Joseph P. Sullivan, has since affirmed. In thereafter granting leave to appeal to this court, it posed the very broad question: “Was the order of the Supreme Court, as affirmed by this Court, properly made?” For the reasons that follow, we conclude a negative response is mandated.

The payor bank’s assault on the conclusion of the courts below is grounded on the contention that there were no factual issues precluding summary judgment and that, on the undisputed facts, its actions were proper as a matter of law for two reasons: (1) [discussion of this issue is

[*] An assignment for the benefit of creditors is a common-law device whereby a debtor assigns substantially all its assets to an assignee, who is charged with liquidating the assets and distributing the proceeds to creditors. Most states have enacted statutes that supplement or supersede the common law assignment.]
omitted] and (2) its conduct in varying the code's midnight deadline pursuant to a valid agreement which accords with custom and usage in the banking community relieves it of the effect of the provisions of article 4 (citing, inter alia, Uniform Commercial Code, § 4–103).

The preliminary dispute as to the existence of unresolved questions of fact need not detain us. The date of the contested transactions and the nonadherence to the midnight deadline, if applicable, were conceded for the purposes of the motion. The payor bank’s officer established the custom as to collection of previously dishonored checks, and the payee’s own submission of the “advice to customer” slip confirmed that the agreement had been made in contemplation of the custom. And, since Graubart’s counsel’s affirmation was made without personal knowledge of the facts, it was not competent to defeat the motion for summary judgment. Leumi’s recitations therefore went undisputed.

Though its [first] point is, therefore, without merit, Leumi’s argument that its retention of the check beyond its midnight deadline was consonant with its agreement with the depositary bank is another matter. In this connection, initially we note that section 4–301 of the code, which establishes the procedural rules enforced by section 4–302, nowhere suggests that the deadline does not apply to previously dishonored items. But, it is well recognized that the code’s requirements can be modified by agreement to conform them with commercial usage, in or out of banking circles, so that parties may advantage themselves of the “wisdom born of accumulated experience” (Bankers Trust Co. v. Dowler & Co., 47 N.Y.2d 128, 134, 417 N.Y.S.2d 47, 50–51, 390 N.E.2d 766, 769). [The court here quoted F4–103(1), (4).]

The concept of an “agreement” under the code is, as with contract law generally, broad enough to permit the written terms of a memorandum to be supplemented and clarified by reference to customs and usages in the commercial milieu in which it is to be performed (e.g., [UCC 1–201(b)(3); UCC 1–303; 3 Corbin, Contracts [1960 ed.], § 556; Walls v. Bailey, 49 N.Y. 464]. But the bare fact that the payor bank acted in accordance with its agreement with the depositary bank does not, in and by itself, relieve the former of liability [UCC 4–203, Comment (last paragraph)]. Section 4–103 demands that every party sought to be bound—here the payee—have assented to the agreement’s terms [UCC 4–103, Comment 2]. However, we hold that here there was such consent.

Under section 4–201 of the code, a payee’s presentment of an item to a depositary bank for collection creates a principal-agent relationship between the two, a status that persists until final settlement (see [UCC 4–201, Comment 4]). Graubart’s voluntary establishment of its bank’s authority constitutes an assent to the latter’s dealing with the check in the manner customary in the banking industry (see Restatement, Agency 2d, § 36). To
the extent that a payee deems itself aggrieved by a depositary bank’s ignoring of limitations on its authority, of which none are claimed here, the law provides recourse against it, but not against a third party who relies on the agent’s apparent authority. . . .

As to good faith and ordinary care, neither of these is a serious obstacle in the circumstances of this case. The payee’s complaint alleges no bad faith or favoritism on the part of the payor bank, and the mere fact that the drawer was indebted to Leumi when it assigned for the benefit of creditors does not permit us to presume collusion in the absence of specific evidence. Moreover, beyond the superficial sense in which ordinary care is relevant to virtually every step in the collection process (see [UCC 4–202(a)]), this standard was not intended to prohibit banking procedures that themselves are reasonable and carried out with care. . . .

Further, in this case the reasonableness of the suspension of the midnight deadline is demonstrated by an examination of the underlying purpose of the rule. Far from merely encouraging banks to process deposited instruments promptly, the deadline plays the central role in “firming up” the provisional credit received by each transferor in the payee—depositary bank—intermediary bank chain. Under section 4–213 of the code [UCC 4–215(c)], provisional credits become final as soon as the payor bank settles for the item and the time for revocation under the midnight deadline passes. This point is particularly critical for banks that funnel hundreds or thousands of checks per day into the collection stream because it enables them to assume that payment has been effectuated after a certain period of time unless there is a prompt return. (See, generally, Blake v. Woodford Bank & Trust Co., 555 S.W.2d 589, 600–601 [Ky.App.]; [F4–213, Comments 7–11].)

These concerns, however, are irrelevant to any evaluation of the custom followed under the agreement between the banks here. It creates no provisional credits that must be firmed up, and the payee can only collect when the payor bank remits its cashier’s check, thus signifying that the drawer’s account received sufficient funds to cover the check. By its nature, the procedure singles out the item as an exceptional one; no transferor will assume it has been paid until specific notice is received.

Moreover, the concept of a midnight deadline is not compatible with any approach under which the payor bank seeks to wait for the deposit of funds in the drawer’s account. The reasonableness of such a banking custom must, therefore, be measured on its own terms. We conclude that this criterion is met when a depositary bank takes a possibly worthless instrument and directs the payor bank to adopt a technique that may provide the only chance for collection.

There is nothing unfair about this procedure. It is calculated to produce satisfied obligations in many instances where legal recourse, with all its attendant expense, inconvenience and uncertainty, would otherwise be
necessary. Furthermore, the payee here cannot claim it was injured by its reliance on the payor bank’s silence after receipt of the item; the prior dishonor provided adequate warning of the questionable safety of the instrument. In any event, the payee’s right to sue the drawer on the underlying obligation was revived upon the first dishonor, and representment in no way cut short that prerogative [F3–802(1)(b) (cf. UCC 3–310(b)(3)); UCC 4–301(c);] Blake v. Woodford Bank & Trust Co., supra).

We therefore hold that the payor bank’s adherence to the depositary bank’s instructions for processing the drawer’s check does not render it liable to the payee under section 4–302. Accordingly, the certified question should be answered in the negative, the order of the Appellate Division reversed, and summary judgment granted in the defendant’s favor on the fourth cause of action.

NOTES ON REPRESENTED CHECKS

(1) Cash Items and Collection Items. Bankers distinguish between “cash items,” which are processed through the automated system described in the Prototype transaction, and “collection items” (referred to in Federal Reserve Regulation J as “noncash items”), which require special handling. Because collection items require special handling, it usually makes no sense to require the payor bank to return the item before the midnight deadline.

The Eleventh Circuit held that the midnight deadline does not apply to collection items. In SCADIF, S.A. v. First Union National, 344 F.3d 1123 (11th Cir. 2003), SCADIF (the payee, a French company) mailed a check to Banque Francaise along with a letter that “confirm[s] our telephone conversation of today whereby we instructed you to send for collection the Ameriplex Group, Inc.’s April 14, 1998 check in the amount of [\$3,215,183.00].” Banque Francaise would forward most checks drawn on a United States bank to its correspondent United States bank, Citibank of New York, for processing through the Federal Reserve System. Instead, it sent the check in question as a one-of-a-kind item directly to First Union. The check was accompanied by a form collection letter that, inter alia, “provided that the check was being sent for collection, identified Ameriplex as the drawee [sic] from whom payment should be obtained, requested payment or notice of dishonor, and requested payment of Banque Francaise's fees.” Banque Francaise did not give SCADIF a provisional credit for the check.

The court acknowledged that First Union met the definition of “payor bank” in UCC 4–104(3). It found, however, that SCADIF and First Union agreed that Banque Francaise, SCADIF’s agent, sent the check to First Union for First Union to pay if and when there were sufficient funds in Ameriplex’s account to cover the check. Accordingly, the check was sent to First Union for collection and “not presented for payment,” and First Union was acting as a collecting bank. Inasmuch as the midnight-deadline rule in
UCC 4–302 is limited by its own terms to items presented to payor banks, First Union was not bound by the midnight deadline.

Read UCC 4–302(a) carefully. It distinguishes between (1) a “demand item,” as to which the payor bank must act by the midnight deadline, and (2) “any other properly payable item,” which the payor bank must pay or return “within the time allowed” for payment. Was the check in SCADIF a demand item within the meaning of UCC 4–302(a)(1)? Was the represented check in David Graubart?

(2) Variation by Agreement. SCADIF’s telephone conversation with and letter to Banque Francaise suggest that SCADIF may have knowingly agreed that the check would be processed as a collection item. Can the same be said for David Graubart, Inc.? On what basis does the court conclude that David Graubart, Inc. assented to the check’s being processed in accordance with the common banking practice described by Bank Leumi’s assistant vice-president?

Is there any limit on the power of banks to vary the midnight deadline by agreement? Could banks by a clearinghouse rule agree that checks could be returned after the midnight deadline? See UCC 4–302 and 4–103(a) and (b), and recall the history of the midnight deadline recounted at p. 124-25, supra.

(B) Payment in Cash or by Irrevocable Settlement

UCC 4–215(a)(3) covers the typical case of final payment: the payor bank fails to take the necessary action to dishonor the item before the midnight deadline passes. Subsections (a)(1) and (a)(2) cover cases of final payment that are not part of the ordinary check-collection process. In fact, both paying the check in cash (UCC 4–215(a)(1)) and settling for the check without having a right to revoke the settlement (UCC 4–215(a)(2)) are quite rare.

Occasionally a payee—usually a consumer—will take a check directly to the payor bank for payment. The experience may be an irritating and time-consuming one for the payee. Unless the payee happens to have an account at the payor bank, the bank may be uneasy about paying a stranger in possession of the check and reluctant to take the risk of paying the wrong person.

What is the payor bank entitled to do in order to satisfy itself that the person in possession of the check is actually the payee? UCC 3–501(b)(2) allows it to demand “reasonable identification.” How long can the payor bank take to satisfy itself? UCC 3–502(b)(2) says that, under these unusual circumstances, the check is dishonored if it “is not paid on the day of presentment.” But UCC 3–501(b)(4) allows the payor bank to fix a “cutoff hour not earlier than 2 P.M.” and treat presentment as occurring on the following day if presentment is made after that hour. Does this mean that
the payee must come back the following day to receive payment? Do these UCC provisions give the payee an action against a payor bank that does not observe them?

A payee may find it much easier to cash a check at its own bank than at the drawer’s. When the payee cashes a check at its own bank, the bank has not “paid the item in cash” within the meaning of UCC 4–215(a)(1). Only a payor bank, i.e., the bank on which the check is drawn, can “pay” a check. Here, the payee’s bank is a only depository bank. Regardless of how it is characterized (a question we consider below), a depository bank’s “cashing” of a check is not “payment” within the meaning of UCC 4–215, let alone “final payment.”

But what if the depository bank and the payor bank are one in the same? Are these checks, which bankers refer to as “on us” items, paid when they are deposited?

**Problem 2.3.3.** Quaker and Empire both bank at The Bank of New York. Empire’s account has only $10,000 in it. Quaker deposits the Empire check in The Bank of New York, which credits Quaker’s account. Later on the same day, when the check is put through the regular computer run, it is rejected as drawn on insufficient funds. What are The Bank of New York’s rights against Quaker? Would your answer be affected by the presence of language like that found on the deposit slip below (“Checks and other items are received for deposit subject to the terms and conditions of this bank’s collection agreement.”)? See UCC 4–214(c); UCC 4–215 & Comment 4; UCC 4–301; UCC 4–302; Kirby v. First & Merchants National Bank, infra.

**Kirby v. First & Merchants National Bank**
Supreme Court of Virginia, 1969.
210 Va. 88, 168 S.E.2d 273.

■ Gordon, Justice. On December 30, 1966, defendant Margaret Kirby handed the following check to a teller at a branch of plaintiff First & Merchants National Bank:

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* [The court’s citations are to the applicable pre–1990 version of the UCC.]
The back of the check bore the signatures of the payees, Mr. and Mrs. Kirby.

Mrs. Kirby, who also had an account with the Bank, gave the teller the following deposit ticket:

The teller handed $200 in cash to Mrs. Kirby, and the Bank credited her account with $2,300 on the next business day, January 3, 1967. The teller or another Bank employee made the notation “Cash for Dep.” under Mr. and Mrs. Kirby’s signatures on the back of the Neuse check.

On January 4 the Bank discovered that the Neuse check was drawn against insufficient funds. Instead of giving written notice, a Bank officer called Mr. and Mrs. Kirby on January 5 to advise that the Bank had

1. The handwriting in the upper-left portion of the deposit ticket corresponds with Mrs. Kirby’s handwriting on the back of the check. The record does not indicate what persons added the other handwritten information on the ticket.

The symbol “68–728–514” designates a check drawn on First & Merchants by a depositor who has an account with a branch of that Bank in the Norfolk–Virginia Beach area. The word following the symbol is “partial.”
dishonored the check and to request reimbursement. Mr. and Mrs. Kirby said they would come to the Bank to cover the check, but they did not. On January 10 the Bank charged Mrs. Kirby's account with $2,500, creating an overdraft of $543.47.

On January 18 the Bank instituted this action to recover $543.47 from Mr. and Mrs. Kirby. At the trial a Bank officer, the only witness in the case, testified:

“Q. Did you cash the check [the Neuse check for $2,500] before you credited this deposit [the deposit of $2,300 to Mrs. Kirby’s account]?

“A. Yes, sir.

“Q. So the bank, in effect, cashed the check for $2,500.00 and then gave the defendant a credit of $2,300.00 to their [sic] account and gave them [sic] $200.00 in cash?

“A. Correct.

“Q. So you cashed the check for $2,500.00?

“A. Yes, sir.”

The trial court, sitting without a jury, entered judgment for the plaintiff First & Merchants, and the defendants Mr. and Mrs. Kirby appeal. The question is whether the Bank had the right to charge Mrs. Kirby’s account with $2,500 on January 10 and to recover from Mr. and Mrs. Kirby the overdraft created by that charge ($543.47).

U.C.C. § 4–213 [R4–215(a)(1)] provides:

“(1) An item is finally paid by a payor bank when the bank has done any of the following, whichever happens first:

“(a) paid the item in cash;”.

So if First & Merchants paid the Neuse check in cash on December 30, it then made final payment and could not sue Mr. or Mrs. Kirby on the check except for breach of warranty.5

When Mrs. Kirby presented the $2,500 Neuse check to the Bank on December 30, the Bank paid her $200 in cash and accepted a deposit of $2,300. The Bank officer said that the Bank cashed the check for $2,500, which could mean only that Mrs. Kirby deposited $2,300 in cash.

And the documentary evidence shows that cash was deposited. The deposit of cash is evidenced by the word “currency” before “2,300.00” on the deposit ticket and by the words “Cash for Dep.” on the back of the check.5

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5. Since no dollar amount was inserted after “checks” on the deposit ticket, the notation “6–28–728–514 partial” was apparently inserted to identify the source of the currency being deposited. See n. 1 supra.
The Bank’s ledger, which shows a credit of $2,300 to Mrs. Kirby’s account rather than a credit of $2,500 and a debit of $200, is consistent with a cashing of the Neuse check and a depositing of part of the proceeds. We must conclude that First & Merchants paid the Neuse check in cash on December 30 and, therefore, had no right thereafter to charge Mrs. Kirby’s account with the amount of the check.

[The court here discusses whether First & Merchants had a right to recover the “final payment” and concludes that it did not.]

Nevertheless, First & Merchants contends that under the terms of its deposit contract with Mrs. Kirby, the settlement was provisional and therefore subject to revocation whether or not the Neuse check was paid in cash on December 30. It contends that in this regard the deposit contract changes the rule set forth in the Uniform Commercial Code. But in providing that “all items are credited subject to final payment”, the contract recognizes that settlement for an item is provisional only until the item is finally paid. Since the deposit contract does not change the applicable rule as set forth in the Uniform Commercial Code, we do not decide whether a bank can provide by deposit contract that payment of a check in cash is provisional.

Even if the Bank’s settlement for the Neuse check had been provisional, the Bank had the right to charge that item back to Mrs. Kirby’s account only if it complied with U.C.C. §§ 4–212(3) [R4–214(c)] and 4–301. Those sections authorize the revocation of a settlement if, before the “midnight deadline”, the bank

“(a) returns the item; or

6. The depositor’s contract provides:

“Items received from deposit or collection are accepted on the following terms and conditions. This bank acts only as depositor’s collecting agent and assumes no responsibility beyond its exercise of due care. All items are credited subject to final payment and to receipt of proceeds of final payment in cash or solvent credits by this bank at its own office. This bank may forward items to correspondents and shall not be liable for default or negligence of correspondents selected with due care nor for losses in transit, and each correspondent shall not be liable except for its own negligence. Items and their proceeds may be handled by any Federal Reserve bank in accordance with applicable Federal Reserve rules, and by this bank or any correspondent, in accordance with any common bank usage, with any practice or procedure that a Federal Reserve bank may use or permit another bank to use, or with any other lawful means. This bank may charge back, at any time prior to midnight on its business day next following the day of receipt, any item drawn on this bank which is ascertained to be drawn against insufficient funds or otherwise not good or payable. An item received after this bank’s regular afternoon closing hour shall be deemed received the next business day.

“This bank reserves the right to post all deposits, including deposits of cash and of items drawn on it, not later than midnight of its next business day after their receipt at this office during regular banking hours, and shall not be liable for damages for nonpayment of any presented item resulting from the exercise of this right.

“* * * “ (Italicized language is quoted in First & Merchants brief.)
"(b) sends written notice of dishonor or nonpayment if the item is held for protest or is otherwise unavailable for return". U.C.C. § 4–301.

The Bank concedes that it neither sent written notice of dishonor nor returned the Neuse check before the "midnight deadline". So the Bank had no right to charge the item back to Mrs. Kirby's account.

For the reasons set forth, the trial court erred in entering judgment for First & Merchants against Mr. and Mrs. Kirby.

Reversed and final judgment.

Harrison, Justice (dissenting). I dissent from the holding of the majority that the check involved here was "cashed". It is apparent that the check of Neuse Engineering and Dredging Company was "deposited" in normal course by Mrs. Kirby, and received and accepted for deposit by the Princess Anne Plaza Branch of the First and Merchants National Bank. The same bank official, quoted by the majority, also testified:

Q. "Did Margaret Kirby or William Kirby bring you a check to deposit on December 29, 1966?
A. "Yes, sir, they did.
Q. "Tell what happened to this particular check.
A. "We received it for deposit on Friday night, the 29th. We deposited $2,300 and gave back cash, $200. * * *"

(Admittedly the correct date of the deposit was Friday, December 30, 1966.)

This witness, the only one who testified in the case, was Mr. Floyd E. Waterfield, Vice President of the bank. From his testimony we learn that late in the afternoon of December 30, 1966, Mrs. Kirby, a customer of the bank with an active checking account, came into the bank with the Neuse check. Apparently she desired $200 in cash. In making out the deposit slip, $2300 was erroneously written opposite the currency line instead of opposite the check line. However, indicated in writing on the face of the deposit slip is a notation that the deposit was evidenced by a check drawn on another of the bank's branches in the Norfolk–Virginia Beach area. Also on the face of the deposit slip is shown the manner in which Mrs. Kirby obtained the $200 she wanted, i.e. by deducting $200 from the $2500 check.

This was a perfectly normal and customary banking transaction. Mrs. Kirby, as a customer of that particular branch bank, presumably could have obtained $200 by writing her personal check, or by having the bank issue and she initial a debit memorandum or charge on her account, or by having the transaction reflected on the face of the deposit slip. She and the bank teller obviously pursued the latter course, and this was entirely in order. When the books of the bank were balanced for the day's operations, the bank had a $2500 check of Neuse, which was offset or balanced against a cash withdrawal of $200, plus a tentative or provisional credit of $2300 in the Kirby checking account.
There is nothing in this record from which it could possibly be deduced that Mrs. Kirby walked into the bank and cashed the Neuse check for $2500. That is, she presented the check and demanded and received $2500 in cash, and afterwards redeposited $2300 of it in currency. This simply did not occur, and the evidence does not reflect it. While the bank officer does refer to “cashing the check”, the evidence and the records of the bank show that it was not cashed, but was accepted for deposit and clearance as any other check.

The fact that the bank permitted Mrs. Kirby to withdraw $200 is of no significance. She was a customer of the bank, with a checking account. Had the withdrawal, absent the Neuse deposit, caused an overdraft, this would not have been unusual for banks permit customers to overdraw from time to time in reasonable amounts. Furthermore, at that time neither Mrs. Kirby nor the bank had reason to anticipate that the Neuse check would be dishonored because of insufficient funds.

. . . .

NOTES ON “ON US” CHECKS

(1) **Need for an Agreement.** In the *Kirby* case, the court concluded that the transaction at the counter on December 30 was “consistent with a cashing of the Neuse check” and that therefore “First & Merchants paid the Neuse check in cash on December 30 and . . . had no right thereafter to charge Mrs. Kirby’s account with the amount of the check.” As UCC 4–215(a) expresses it: “An item is finally paid by a payor bank when the bank has . . . paid the item in cash . . . .”

Suppose, however, that the bank had not given $200 in cash to Mrs. Kirby; that nothing had been entered on the deposit slip under “currency”; and that “$2,500” had been entered under “checks” and under “Total.” Would the check then have been paid at the time that the teller took the check and the deposit slip at the counter or at some other time?

A leading pre-UCC case on this point was White Brokerage Co. v. Cooperman, 207 Minn. 239, 290 N.W. 790 (1940), which held that a check presented over the counter was paid when the bank completed the transaction at its counter. This rule was not calculated to please banks whose tellers were too busy to look up each “on us” item as it came over the counter, nor perhaps the depositors who would be required to wait at the window while this was done. The simplest answer was a properly drafted clause in the deposit slip, making the settlement provisional, subject to revocation. Bank Collection Code § 3 made it provisional, even in the absence of such a clause at least until the end of the day of deposit. The UCC deals with the problem in UCC 4–301(a) and (b) and UCC 4–215(a).

To make these sections work, one must distinguish the situation in which a payor bank pays a check in cash from one in which the check is
“received by the payor bank for credit on its books” and some of that credit is withdrawn.

In Douglas v. Citizens Bank of Jonesboro, 244 Ark. 168, 424 S.W.2d 532 (1968) (decided under Former Article 4), the court affirmed the ruling of the trial judge that a payor bank in which on us checks were deposited did not pay the checks when the teller took them. Like the trial judge, the supreme court gave no consideration to language on the deposit slips that purported to give the bank a right to charge back any on us items that are “not good.” This outcome appears consistent with UCC 4–301(b), which governs cases in which a demand item is received by a payor bank for credit on its books.” In these circumstances, the bank “may return the item . . . and may revoke any credit given or recover the amount thereof withdrawn by its customer” if it does so before it has made final payment and before its midnight deadline. As UCC 4–215, Comment 4, indicates: “In any case in which Section 4–301 is applicable, any settlement by the payor bank is provisional solely by virtue of the statute, subsection (a)(2) of Section 4–215 does not operate, and such provisional settlement does not constitute final payment of the item.”

In Douglas the payees apparently did not receive any cash from the teller. Thus it seems rather clear that the checks were “received by the payor bank for credit on its books” and that, accordingly, the bank had a statutory right to revoke its settlement. But suppose the payee delivers the check and receives cash in return? Assume that the customer signs the deposit slip to acknowledge receipt of the cash, and that the “Total” reflects the amount of the check less the amount of cash. Has the bank “received the check for credit on its books” and allowed the depositor to withdraw this provisional credit (or credit already in the account)? If so, then final payment has not occurred. Or has the bank “paid the item in cash,” in which case final payment has occurred?

(2) Branches and the Midnight Deadline. In the Kirby case, First & Merchants conceded that it neither sent written notice of dishonor nor returned the Neuse check before the midnight deadline. But when did the midnight deadline start to run? The Neuse check apparently was drawn on a different branch of First & Merchants from the one to which Mrs. Kirby took it. Did the payor bank’s midnight deadline start to run at the time Mrs. Kirby gave the check to the teller at the Princess Anne Plaza branch or at the time the check was received by the branch on which it was drawn (or the branch’s processing center)? UCC 4–107 may be helpful in this regard. It provides that “[a] branch or separate office of a bank is a separate bank for the purpose of computing the time within which and determining the place at or to which action may be taken or notices or orders shall be given under this Article and under Article 3.”

Does UCC 4–107 resolve the question whether the check was paid in cash? Recall that only a payor bank can pay a check. Does the fact that the two branches are treated separately for purposes of the midnight deadline necessarily mean that the Princess Anne Plaza branch is not the payor
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bank? UCC 4–107 considers a branch to be a separate bank only for certain purposes: (1) computing the time within which action may be taken or notices or orders shall be given and (2) determining the place at or to which action may be taken or notices or orders shall be given. Comment 1 explains why the provision is limited in this way:

A rule with respect to the status of a branch or separate office of a bank as part of any statute on bank collections is highly desirable. However, practices in the operations of branches and separate offices vary substantially in the different states and it has not been possible to find any single rule that is logically correct, fair in all situations and workable under all different types of practices. The decision not to draft the section with greater specificity leaves to the courts the resolution of the issues arising under this section on the basis of the facts of each case.

For purposes of resolving the issues in Kirby, does the text of UCC 4–107 require that the Princess Anne Center branch be considered a separate bank? If not, what facts would be relevant to determining whether a court should treat it as such? See UCC 4–107, Comment 2.

SECTION 4. PAYOR BANK’S DUTIES ON DISHONOR

A moment’s reflection will reveal that even imposing a midnight deadline on the payor bank (and, as is generally the case, on each returning bank, see UCC 4–202) does not eliminate the delay between the time the payor bank dishonors a check and the time the depositary bank learns of the dishonor. More than 99 percent of checks are paid, but depositary banks are concerned about the small portion of checks that are not. They fear that they will allow their customers to draw on the funds represented by a deposited check, only to learn later that the check has been dishonored. As we shall see below in Section 5(A), a depositary bank that permits a customer to draw on uncollected funds has a right to recover the amount withdrawn if the check is dishonored. Although a right to recover may have value, in many circumstances a depositary bank would prefer to eliminate any need to recover in the first instance. Accordingly, to address the delay between dishonor and the depositary bank’s receipt of notice of dishonor, depositary banks impose a “hold” period on many customers’ accounts.

F4–213(4)(a) allowed a depositary bank to place a hold on funds represented by deposited checks in order to give the bank a “reasonable time” to learn that they had been paid. This laissez-faire attitude permitted holding periods in some cases of six business days for local checks and fifteen business days for nonlocal checks. See Rapp v. Dime Savings Bank, 48 N.Y.2d 658, 421 N.Y.S.2d 347, 396 N.E.2d 740 (1979).

Depositary banks justified such long holds by citing the UCC’s slow scheme for return of unpaid checks. If the payor bank paid the item, each
of these provisional credits along the collection chain automatically “firmed up,” becoming a final credit. Under this system, no news was good news, and the depositary bank, after a time, simply assumed that the check had been paid. If, however, the payor bank refused to pay the check, the presenting bank would return the check to the collecting bank from which it had received it, revoking the provisional credit previously given. Each prior bank in the collection chain then did the same. Because the return of a check retraced the forward collection path, the return process was often slow and cumbersome. Hence, long holds seemed necessary to protect depositary banks.

Extended hold periods became a major consumer issue in the 1980s and ultimately led to the passage of the Expedited Funds Availability Act of 1987, 12 U.S.C. § 4001 et seq. The Act granted to the Fed broad authority to regulate the payment system: “In order to carry out the provisions of this chapter, the Board of Governors of the Federal Reserve System shall have the responsibility to regulate . . . any aspect of the payment system, including the receipt, payment, collection, or clearing of checks . . . .” Acting pursuant to this authority, the Fed promulgated Regulation CC (12 C.F.R. 229) in 1988.

Reg CC addresses concerns of both consumers and banks. First, it requires banks to make deposited funds available to customers within the periods fixed by a mandatory availability schedule. These periods are discussed below in Section 6(B). Second, Reg CC attempts to protect depositary banks saddled with early availability by speeding up the return of unpaid checks. This Section considers the return process.

Problem 2.4.1. Quaker deposited the Empire check at PNC Bank on Tuesday, at which time PNC Bank credited Quaker’s account with the amount of the check. On Wednesday, The Bank of New York receives the check from the Federal Reserve Bank of Philadelphia, to which PNC Bank had sent it for collection. The check is rejected when it is put through The Bank of New York’s regular computer run. The Bank of New York mislays the check. A clerk finds it at 11:00 p.m. on Thursday and immediately deposits it in the U.S. mail in an envelope addressed to PNC Bank. PNC Bank receives the check on Tuesday morning. Meanwhile, on Monday afternoon Quaker withdrew its entire balance and closed its account at PNC Bank. What are PNC Bank’s rights against The Bank of New York?

(a) Has The Bank of New York paid the Empire check? See UCC 4-215; UCC 4-301.

(b) Does The Bank of New York face any liability under Reg CC? See Regulation CC 229.30(a); 229.33(a); 229.34(a); 229.38.

NOTES ON THE PAYOR BANK’S DUTIES WITH RESPECT TO DISHONORED CHECKS
(1) Dishonor. Dishonor serves two separate purposes. The first is to notify the depositary bank and its customer that the check has not been paid. Since the depositary bank never receives notice of payment, the notice of dishonor is the only way it learns the status of the check. When a dishonor arrives, it signals the depositary bank to reverse (“charge back”) the provisional credit it has given to the payee and, if the payee has already withdrawn the funds, to proceed with efforts to recover the funds. Likewise, notice of dishonor informs the payee that the check has not been paid and enables the payee to take the necessary action against the drawer. As we saw supra in Note (8), p. 41, dishonor of a negotiable instrument revives the obligation for which the instrument was taken, and the payee can proceed against the drawer on that basis. In addition, when a check is dishonored, Article 3 gives the person entitled to enforce the check an action “on the instrument,” i.e., on the drawer’s obligation to pay the check on dishonor. See UCC 3–414(b). Normally, the PETETI will be the payee, although the depositary bank may assert this cause of action if it is unable to recover from the payee.

The action on the dishonored check usually requires the physical return of the check itself. The other actions—the depositary bank’s right to reverse a provisional credit and recover withdrawn funds and the payee’s right to recover from the drawer on the obligation for which the check was taken—simply require notification that the check has been dishonored. This was of no great significance at a time when the fastest way to transmit information was on pieces of paper. With the invention of the telegraph and the subsequent development of electronic communications, however, the difference between notification of dishonor and return of the item becomes highly significant. Nevertheless, the UCC generally ties its dishonor rules to return of the physical item. See UCC 4–301.

(2) Direct Return. Prior to Reg CC, each bank that settled for an item during forward collection normally gave a provisional credit. The provisional credits “firmed up” upon final payment of the check. When the payor bank dishonored a check, it returned the check to the presenting bank and the provisional credit given to the presenting bank was reversed. To enable the entire series of provisional credits to be reversed, checks were returned along the forward-collection path, but in reverse. Thus, in the Prototype transaction, dishonor would have resulted in The Bank of New York’s returning the Empire check to Citibank through The Clearing House, which would have taken into account a credit for The Bank of New York and a debit for Citibank in establishing each bank’s net position for the day. Citibank would recover the credit it gave to PNC Bank by returning the check to PNC Bank. PNC Bank, in turn, would charge back the amount of the check against Quaker’s account and return the check to Quaker.

Regulation CC marks a major change in the check-collection process. It provides that “Settlements between banks for the forward collection of a
check are final when made.” Reg CC 229.36(d). By eliminating the practice of giving provisional credit between banks, Reg CC eliminates the need to revoke provisional credits by retracing the forward collection path. Instead, the Regulation authorizes direct return of a dishonored item to the depositary bank and requires that returns be expeditious. Reg CC 229.30(a). Thus, at least in a well-ordered world, a depositary bank will know that the payor bank has refused to pay a check before the depositary bank must allow the customer to draw against that check.

(3) Expeditious Return. The UCC’s emphasis on the bank’s timely dispatch of unpaid items did nothing to encourage expeditious return. Each bank’s job was to rid itself of an item before its midnight deadline, rather than to choose an efficient method of return. As a consequence, the return of a check often involved a slow retracing of the forward collection path until the check finally reached the depositary bank.

Regulation CC changes this. It retains the midnight deadline rule in most cases, but also requires the payor bank (and other banks handling a returned item) to return a dishonored check in an expeditious manner. A bank that meets its midnight deadline but fails in its duty of expeditious return may be liable for damages caused to the depositary bank or its customer.

To fulfill the duty of expeditious return, a payor bank’s return must satisfy either the the two-day/four-day test or the forward collection test. Reg CC 229.30(a)(1), (2).

The Two-day/Four-day Test. A payor bank returns a check expeditiously if it returns it in such a way that it normally would be received by the depositary bank within two days if the banks are in the same check-processing region and within four days if they are in different regions. If the banks are in the same region, a check is returned expeditiously if it is returned in such a manner that it normally would be received by the depositary bank by 4:00 p.m. (local time of the depositary bank) of the second business day after the banking day on which the check was presented to the payor bank. For example, if the payor bank decides to dishonor a check presented on Monday, it returns the check expeditiously if the check normally would be received by a depositary bank in the same check-processing region by 4:00 p.m. on Wednesday. If the banks are not in the same region, a check is returned expeditiously if it normally would be received by the depositary bank by 4:00 p.m. of the fourth business day after the banking day on which the check was presented to the payor bank (here, Monday). The payor bank need not establish that the depositary bank actually received the check within the specified time. It need show only that it sent the check in such a way that the payor bank normally would have received the check within that time. The Commentary to Reg CC 229.30(a) explains:
The times specified in this two-day/four-day test are based on estimated forward collection times, but take into account the particular difficulties that may be encountered in handling returned checks. It is anticipated that the normal process for forward collection of a check coupled with these return requirements will frequently result in the return of checks before the proceeds of nonlocal checks, other than those covered by §229.10(c), must be made available for withdrawal.

The Forward Collection Test. A payor bank satisfies the forward collection test if it returns a check in the manner that a similarly situated bank would collect a check (1) of similar amount, (2) drawn on the same depositary bank, and (3) deposited for forward collection by a similarly situated bank by noon on the banking day following the banking day on which the check was presented to the payor bank. Underlying this test is the assumption that since forward collection is usually swift, the return process will be expeditious if it follows the same route that depositary banks choose for forward collection. The expeditiousness of a payor bank's return is measured against community standards established for forward collection. For example, if a payor bank generally mails its forward collection checks to a Federal Reserve Bank, but similarly situated banks use a courier to forward checks to a Federal Reserve Bank, the payor bank must return checks by courier to satisfy the forward collection test. A bank is similarly situated if it is of similar asset size, in the same community, and with similar check-handling activity.

Qualified Returned Checks. Reg CC allows a payor bank to convert a check to a qualified return check by encoding the check in magnetic ink with the routing number of the depositary bank, the amount of the check, and a return identifier. Conversion of a check to a qualified return check may expedite handling by returning banks. The Regulation does not, however, encourage such conversion by relaxing the return timetable for a payor bank that elects to qualify a check.

Direct Return. Under either the two-day/four-day test or the forward collection test, the payor bank may return a check directly to the depositary bank. Rec CC 229.30(a). The provision is significant, because direct return was not authorized by the UCC in every state. See UCC 4–212(2). Alternatively, the payor bank may route the check to a Federal Reserve Bank or any returning bank that agrees to handle the check expeditiously, whether or not that bank participated in forward collection of the check. The ability to return a check through a non-collecting bank is an important departure from the UCC, which required return of a check through the chain of forward collection.

If a payor bank, through no fault of its own, cannot identify the depositary bank, the expeditious return requirements do not apply. The payor bank may send the check to any bank that handled it for forward collection, whether or not that bank agrees to return the check.
expeditiously. In such cases, the payor bank is still required to meet its midnight deadline under the UCC. This scenario should occur only rarely since Regulation CC imposes strict indorsement standards designed to ensure easy identification of the depositary bank.

In addition to its duty of expeditious return, the payor bank generally must meet its midnight deadline under the UCC. However, the Regulation removes the midnight-deadline constraint where doing so will further the Regulation’s paramount goal of expeditious return. As we have seen in Note (4) on the Midnight Deadline, supra, the payor bank is not bound by its midnight deadline if it dispatches the check so that ordinarily it would be received by the receiving bank’s next banking day following the midnight deadline. The payor bank’s midnight deadline is extended further if it uses a “highly expeditious means of transportation.”

In all cases, the payor bank must indicate clearly on the face of the check the reason for return, a practice that has been traditional among banks, though not required by the UCC. If neither the check nor a copy of the check is available, the payor bank may send a written notice of nonpayment in lieu of return. This notice is subject to the same standard of expeditious return as the check itself.

**Returning Banks.** Regulation CC also imposes a duty of expeditious return on a returning bank that has agreed to handle a check for expeditious return (probably for a fee). Reg CC 229.31(a). Unlike the UCC, which authorizes return through all banks in the forward collection chain, the Regulation authorizes return only through banks that have agreed to handle the check for expeditious return. Participation in forward collection does not constitute such an agreement.

If a bank does agree to return a check it must satisfy either the two-day/four-day test or the forward collection test. The two-day/four-day test employs the same standard applied to payor banks.

The forward collection test, while similar to the forward collection test for payor banks, allows a returning bank to set a cut-off hour for receipt of returned checks that is earlier than a similarity situated bank’s cut-off hour for checks received for forward collection, but no earlier than 2:00 p.m. In addition, the timetable under the forward collection test is extended by one business day if the returning bank elects to convert a returned check to a qualified returned check. The returning bank may return a check directly to the depositary bank or through a returning bank, including a Federal Reserve Bank that has agreed to handle the check expeditiously.

**(4) Notice of Nonpayment.** Note (1) explains that the notice function of dishonor can be satisfied without return of the dishonored item. Unlike the UCC, Reg CC disaggregates the notice function from the return of the check.

Reg CC 229.33 requires a payor bank to provide a depositary bank with notice of nonpayment of any check of $2,500 or more. This notice requirement is in addition to the payor’s duty of expeditious return. The
duty is satisfied only if the depositary bank *actually receives* the notice of nonpayment by 4:00 p.m. on the second business day following the banking day of presentment. Upon receiving notice of nonpayment, the depositary bank must notify its customer before its midnight deadline or within a longer reasonable time.

Notice may be provided by any reasonable means, including the check itself, a writing, telephone, or wire. Notice must include the (1) name and routing number of the payor bank; (2) name of payee; (3) amount; (4) date of depositary bank’s indorsement; (5) depositor’s account number; (6) depositary bank’s branch name or number from its indorsement; (7) trace number associated with depositary bank’s indorsement; and (8) reason for nonpayment. If written notice is sent, it also must include the depositary bank’s name and routing number from its indorsement.

UCC 4–301(a)(2) requires notice of nonpayment only where the check itself is unavailable for return. The notice requirement, like other Code provisions, may be varied by agreements to which the parties did not specifically assent, such as Federal Reserve regulations and operating circulars. See UCC 4–103(b); Wells Fargo Bank v. Hartford National Bank & Trust Co., 484 F.Supp. 817 (D.Conn.1980). The notice requirements of Regulation CC cannot be varied so easily because the Regulation rejects the UCC’s position that parties can be bound by agreements to which they have not assented. See Reg CC 229.37 and Commentary thereto.

(5) Liability. Banks must exercise ordinary care and act in good faith in complying with the requirements of Reg CC with respect to the collection and return of checks. A bank failing to satisfy this standard of care may be liable to the depositary bank, the depositary bank’s customer, the owner of the check, or another party to the check. The measure of damages is the amount of actual loss, i.e., the amount of loss incurred, up to the amount of the check, less the amount of loss that would have been incurred had the bank exercised ordinary care. If a bank fails to act in good faith it also may be liable for other damages proximately caused by its failure. Reg CC 229.38.

In cases involving lack of due care by more than one bank, Regulation CC applies a “pure” comparative negligence rule. See Reg CC 229.38(c) and Commentary thereto. Damages for which a person, including a bank, is liable are reduced in proportion to the negligence or bad faith of another person.

**SECTION 5. DEPOSITORY BANK’S RIGHTS WITH RESPECT TO DISHONORED CHECKS**

A depositary bank that receives a returned (dishonored) check must pay the amount of the check to the bank that returns it. This payment must be
made prior to the close of business on the banking day on which the check is received. Reg CC 229.32(b). The depositary bank then will seek to recover the amount of the payment (i.e., the amount of the check). In this Section we consider the variety of rights that a depositary bank enjoys with respect to dishonored checks.

**A) Depositary Bank’s Right of Charge-back**

Perhaps the easiest way for a depositary bank that pays for a returned check to make itself whole is to proceed against its customer, the depositor. UCC 4–214(a) sets forth the circumstances under which a depositary (or other collecting) bank may “revoke the [provisional] settlement given by it” and “charge back the amount of any credit given for the item to its customer’s account, or obtain refund from its customer.” These are explored in the following Problems.

**Problem 2.5.1.** PNC Bank, after giving Quaker a provisional credit on Tuesday, January 26, negligently mislaid the Empire check and did not forward it until Monday, February 1. Because Empire became insolvent, The Bank of New York dishonored the check by returning it to The Clearing House on the day of presentment, Tuesday, February 2, and sending a timely notice of nonpayment. PNC promptly returned the check to Quaker and revoked the credit. Quaker disputed PNC’s right to do this, arguing that the Empire check would have been paid if PNC had forwarded the check promptly. Quaker drew checks against the disputed $22,178.50 credit. PNC marked the checks “N.S.F.” and dishonored them. Quaker sues PNC for wrongful dishonor. What result? See UCC 4–202; UCC 4–214(a) and Comment 5; UCC 4–103(e).

**Problem 2.5.2.** What result in the preceding Problem if PNC Bank did not return the Empire check or notify Quaker until February 28?

**Problem 2.5.3.** Under the facts of the Problem 2.5.1:

(a) What result if The Bank of New York did not return the Empire check to The Clearing House until February 4?

(b) Would the result in part (a) of this Problem be affected if the PNC Bank deposit agreement contained the following sentence:

If a cashed or deposited item is returned to us at any time for any reason, including for any breach of warranty claim, or according to any law, regulation or rule (including a clearinghouse rule), by the bank on which it is drawn or any collecting bank, we may accept that return and charge the item back against your account without regard to whether the other bank finally paid the item or returned the item in accordance with any applicable midnight deadline or clearinghouse rule.

See UCC 4–103(a), (b).

(c) If, in part (b), the deposit agreement gives PNC Bank an enforceable right to revoke the provisional credit, Quaker will seek to recover the
amount of the check from The Bank of New York. (Recall that Empire has become insolvent.) What rights, if any, does Quaker have against The Bank of New York under these circumstances? See UCC 3–409; UCC 4–302; Reg CC 229.34(a)(1). Would these rights be equivalent to the rights that Quaker would enjoy in part (a)?

(B) DEPOSITARY BANK’S RECOVERY ON WARRANTY

**Problem 2.5.4.** Rather than deposit the check in its bank account, Quaker indorsed the check to a related corporation, Quark, which deposited the check in its account at PNC Bank. The Bank of New York properly dishonored the check and returned it to PNC. Because Quark was a good customer, PNC had made the uncollected funds available immediately. Before PNC learned of the dishonor, Quark closed the account and filed for bankruptcy. Unable to charge back or obtain a refund from Quark, PNC wishes to recover from Quaker or Empire.

(a) Does PNC have any rights against Quaker:
   (i) under UCC 4–214?

(b) Does PNC have any rights against Empire:
   (i) under UCC 4–214?

NOTES ON WARRANTIES

Article 3 and Article 4 each contains two sets of warranties, “transfer warranties” and “presentment warranties.” Except for UCC 4–207(b), which applies to dishonored items, the provisions governing transfer warranties in UCC 4–207 conform to the transfer-warranty provisions in UCC 3–416. Likewise, the provisions governing presentment warranties in UCC 4–208 conform to those in UCC 3–417.

For most purposes, then, where a check has been handled, it does not matter whether the Article 3 or Article 4 warranties apply. However, because the substance of the transfer warranties differs in certain material respects from the presentment warranties, it is essential to determine whether a person has made the transfer warranties, the presentment warranties, or both.
Article 3 transfer warranties are made by “a person who transfers an instrument for consideration.” UCC 3–416(a). In the case of Article 4, these warranties are made by “[a] customer or collecting bank that transfers an item and receives a settlement or other consideration.” UCC 4–207(a). UCC 3–203(a) explains when an instrument is “transferred.” As the name suggests, presentment warranties arise upon “presentment,” which is defined in UCC 3–501(a). The presentment warranties in UCC 4–208 apply to checks that are presented to the drawee bank for payment or acceptance (certification); however, presentment warranties are made not only by the person making presentment but also by a previous transferor of the presented item.

In determining whether a person is liable for breach of warranty, one must answer several questions: (1) Which warranties, if any, did the person make? (2) Of these, which warranties, if any, did the warrantor breach? (3) To whom were the warranties made? (4) What is the amount of damages? (5) Has any or all of the warrantor’s liability been discharged by the failure of the injured person to give timely notice of its claim? Each of the warranty sections (UCC 3–416 and UCC 4–207 with respect to transfer warranties; UCC 3–417 and UCC 4–208 with respect to presentment warranties) answers these questions.

(C) DEPOSITORY BANK’S RECOVERY ON THE INSTRUMENT

We saw in Chapter 1, Section 2, that a person who signs a negotiable instrument incurs an obligation to pay the instrument upon dishonor. The following Problems consider the extent to which a depositary bank can enforce that obligation against its customer and the drawer of the dishonored check.

Problem 2.5.5. Instead of depositing the Empire check in its account for collection, Quaker asked PNC Bank to “cash” it. Quaker indorsed the check and delivered it to PNC, which paid Quaker $22,178.50 in cash. The Bank of New York dishonored the check because Empire had stopped payment. Empire justifiably stopped payment and tendered the cans to Quaker after discovering that the cans were defective. PNC is unable to charge back because no “hold” was placed on Quaker’s account. Quaker is now insolvent.

(a) Does PNC have a right to recover the $22,178.50 from Empire? See UCC 3–414; UCC 3–305; UCC 3–302; UCC 4–211; UCC 4–210(a).

(b) What result if Empire can prove that it is highly unusual for banks in the Philadelphia area to cash a check for such a large amount?

(c) What result if PNC did not cash the check until two months after its issue? See UCC 3–304(a); UCC 1–202(a). What is the difference between the 90–day period of UCC 3–304(a)(2) and the 30–day period of UCC 3–414(f)?

(d) What result if Quaker neglected to indorse the check and PNC’s teller did not notice? See UCC 3–201; UCC 3–203; UCC 4–205.
Problem 2.5.6. Quaker indorsed the Empire check and deposited it in its account at PNC Bank. The Bank of New York dishonored the check because Empire had stopped payment. Empire justifiably stopped payment and tendered the cans to Quaker after discovering that the cans were defective. PNC is unable to charge back because Quaker's account is overdrawn and Quaker is insolvent.

(a) Does PNC have a right to recover $22,178.50 from Empire?
(b) Does any of the following affect the answer to part (a)?

(i) Empire can prove that Quaker’s account was frequently overdrawn. See UCC 3–104(a)(4) & Comment 4.
(ii) The assistant cashier of PNC telephoned a vice president of The Bank of New York before cashing the check and was assured that the check is “good” and that The Bank of New York has had no problems with Empire’s checks in the past.
(iii) The assistant cashier of PNC was told that Empire’s balance in The Bank of New York is too low to cover the check.

Maine Family Federal Credit Union v. Sun Life Assurance Co.
Supreme Judicial Court of Maine, 1999.
727 A.2d 335.

SAUFLEY, J.

We are called upon here to address the concept of “holder in due course” as defined by recent amendments to the negotiable instruments provisions of the Maine Uniform Commercial Code. We conclude that, pursuant to those amendments, the Superior Court (Cumberland County, Calkins, J.) did not err when it entered a judgment based on the jury’s finding that the Maine Family Federal Credit Union was not a holder in due course. Because we find, however, that Sun Life Assurance Company was not entitled to raise a third party’s defense of fraud to its liability as drawer of the instruments, we vacate that portion of the judgment entered in favor of Sun Life and against the Credit Union.

I. Facts

Daniel, Joel, and Claire Guerrette are the adult children of Elden Guerrette, who died on September 24, 1995. Before his death, Elden had purchased a life insurance policy from Sun Life Assurance Company of Canada, through Sun Life's agent, Steven Hall, and had named his children as his beneficiaries. Upon his death, Sun Life issued three checks, each in the amount of $40,759.35, to each of Elden’s children. The checks were drawn on Sun Life’s account at Chase Manhattan Bank in Syracuse, New York. The checks were given to Hall for delivery to the Guerrettes.
The parties have stipulated that Hall and an associate, Paul Richard, then fraudulently induced the Guerettes to indorse the checks in blank and to transfer them to Hall and Richard, purportedly to be invested in “HER, Inc.,” a corporation formed by Hall and Richard. Hall took the checks from the Guerettes and turned them over to Richard, who deposited them in his account at the Credit Union on October 26, 1995. The Credit Union immediately made the funds available to Richard.

The Guerettes quickly regretted having negotiated their checks to Hall and Richard, and they contacted Sun Life the next day to request that Sun Life stop payment on the checks. Sun Life immediately ordered Chase Manhattan to stop payment on the checks. Thus, when the checks were ultimately presented to Chase Manhattan for payment, Chase refused to pay the checks, and they were returned to the Credit Union.

The Credit Union filed a complaint against Sun Life alleging that Sun Life was liable as drawer of the instruments, and that Sun Life had been unjustly enriched at the Credit Union’s expense. [The Credit Union also filed a cross-claim against Daniel Guerrette and Paul Richard, alleging that they were liable as indorsers of the checks.] . . .

The Credit Union moved for summary judgment. The Superior Court held, as a matter of law, that Daniel Guerrette had raised a “claim of a property or possessory right in the instrument or its proceeds,” 11 M.R.S.A. § 3–1306 (1995), and therefore that Sun Life was entitled to assert that claim as a “defense” against the Credit Union. See 11 M.R.S.A. § 3–1305(3) (1995). The court found, however, that a genuine issue of material fact remained as to whether the Credit Union had acted in “good faith” when it gave value for the checks—a fact relevant to determining whether the Credit Union was a holder in due course. See 11 M.R.S.A. § 3–1302(1)(b)(ii) (1995). Accordingly, the court denied the Credit Union’s motion for summary judgment, and the matter proceeded to trial.

At trial, the only issue presented to the jury was whether the Credit Union had acted in “good faith” when it gave value for the checks, thus entitling it to holder in due course status.10 At the close of evidence, the Credit Union made a motion for a judgment as a matter of law, which the Superior Court denied. The jury found that the Credit Union had not acted in good faith and therefore was not a holder in due course. Therefore, the Superior Court entered judgment in favor of Sun Life, . . . and against the Credit Union. The court denied the Credit Union’s renewed motion for

10. The parties stipulated to the fact that Daniel, Joel, and Claire were defrauded by Hall and Richard, and Paul Richard consented to the entry of judgment against him in the amount of $42,366.56 on the Credit Union’s cross-claim against him. In addition, the parties stipulated that the Credit Union had incurred damages in the amount of $42,366.56. The parties’ cooperation in crafting the stipulations appropriately allowed the court and the jury to focus on the only issue in dispute.
judgment as a matter of law and motion to amend the judgment, and the Credit Union filed this appeal.

II. Obligations of the Parties

At the heart of the controversy in this case is the allocation of responsibility for the loss of the unpaid $42,366.56, given the fact that Paul Richard and Steven Hall, the real wrongdoers, appear to be unable to pay. Maine, like the other forty-nine states, has adopted the Uniform Commercial Code. Under the Maine U.C.C., Articles 3-A and 4 deal with “Negotiable Instruments” and “Bank Deposits and Collections.” See 11 M.R.S.A. §§ 3–1101, 4–101 (1995). It is these statutes that govern the parties’ dispute.

Pursuant to Article 4 of the Maine U.C.C., the Credit Union, as a depositary bank, is a “holder” of the instruments, see 11 M.R.S.A. § 4–205(1) (1995), making it a “person entitled to enforce” the instrument under Article 3-A. See 11 M.R.S.A. § 3–1301(1) (1995). Upon producing an instrument containing the valid signature of a party liable on the instrument, a person entitled to enforce the instrument is entitled to payment, unless the party liable proves a defense or claim in recoupment, see 11 M.R.S.A. § 3–1308(2) (1995), or a possessory claim to the instrument itself. See 11 M.R.S.A. § 3–1306.

Because their signatures appear on the backs of the checks, Daniel, Joel, and Claire are “indorsers” of the checks. See 11 M.R.S.A. § 3–1204(1), (2) (1995). As indorsers, they are obligated to pay the amounts due on each dishonored instrument “[a]ccording to the terms of [each] instrument at the time it was indorsed.” 11 M.R.S.A. § 3–1415(1)(a) (1995). This obligation is owed “to a person entitled to enforce the instrument or to a subsequent indorser who paid the instrument under this section.” Id.

As drawer of the checks, Sun Life is obligated to pay each dishonored instrument “[a]ccording to its terms at the time it was issued.” 11 M.R.S.A. § 3–1414(2)(a) (1995). Again, this obligation is owed to a person entitled to enforce the instrument or to an indorser who paid the draft under section 3–1415. See 11 M.R.S.A. § 3–1414(2) (1995). Chase Manhattan, as drawee of these checks, was not obligated to accept them for payment, see 11 M.R.S.A. § 3–1408 (1995), and therefore has not been made a party to this action.

12. 11 M.R.S.A. § 4–205(1) provides that a depositary bank becomes a holder of an item if the item was deposited by a customer who was also a holder. The Credit Union’s customer, Paul Richard, became a holder of the checks when Daniel, Joel, and Claire indorsed them in blank and transferred them to Richard and Hall. See 11 M.R.S.A. § 3–1201(1) (1995) (“Negotiation’ means a transfer of possession, whether voluntary or involuntary, of an instrument by a person other than the issuer to a person who thereby becomes its holder.”); 11 M.R.S.A. § 3–1202(1)(b) (1995) (“Negotiation is effective even if obtained . . . [b]y fraud.”).
Unless the Credit Union is a holder in due course, its right to enforce the obligations of the drawer and indorsers of the instruments is subject to a variety of defenses, including all those defenses available “if the person entitled to enforce the instrument[s] were enforcing a right to payment under a simple contract.” See 11 M.R.S.A. § 3–1305(1)(b) (1995). In addition, its right to enforce is subject to any claims in recoupment, see 11 M.R.S.A. § 3–1305(1)(c) (1995), or claims to the instruments themselves. See 11 M.R.S.A. § 3–1306. If, however, the Credit Union establishes that it is a “holder in due course,” it is subject to only those few defenses listed in section 3–1305(1)(a). See 11 M.R.S.A. § 3–1305(2) (1995). None of those specific defenses is applicable here. Thus, the Credit Union argues that because it is entitled as a matter of law to holder in due course status, it is entitled to enforce the instruments against the Guerrettes and Sun Life.

III. Holder in Due Course

A. Burden of Proof and Standard of Review

A holder in due course is a holder who takes an instrument in good faith, for value, and without notice of any claims or defenses. See 11 M.R.S.A. § 3–1302(1) (1995). Once the persons who may be liable on the instruments have raised a recognized defense to that liability, the burden is on the holder to prove by a preponderance of the evidence that it is a holder in due course. If it fails in that proof, the persons otherwise liable on the instruments may avoid liability if they prove a defense, claim in recoupment, or possessory claim to the instrument. See 11 M.R.S.A. §§ 3–1305(1)(b), 3–1308(2).

. . . . In this case, the Superior Court declined to decide the holder in due course issue as a matter of law, and submitted the question to the jury. The jury found that the Credit Union was not a holder in due course, implicitly because the Credit Union did not act in good faith.

The Credit Union argues that the court erred in failing to find, as a matter of law, that it was a holder in due course. . . . The question before us, therefore, is whether any reasonable view of the evidence, along with any justifiable inferences therefrom, can possibly support the jury’s conclusion that the Credit Union did not act in good faith and therefore was not a holder in due course. Alternatively stated, the question is whether the evidence compelled a finding that the Credit Union was a holder in due course. If there is any rational basis for the jury’s verdict, we must affirm the judgment.

B. Good Faith

We therefore turn to the definition of “good faith” contained in Article 3-A of the Maine U.C.C. In 1990, the National Conference of Commissioners on Uniform State Law recommended substantial changes in the U.C.C. The Maine Legislature responded to those recommendations in 1993 by repealing the entirety of Article 3 and enacting a new version entitled
Article 3-A, which contains a new definition of “good faith.” While the previous version of the good faith definition only required the holder to prove that it acted with “honesty in fact,” the new definition provides:

“Good faith” means honesty in fact and the observance of reasonable commercial standards of fair dealing.

11 M.R.S.A. § 3–1103(1)(d) (1995) (emphasis added). Because the tests are presented in the conjunctive, a holder must now satisfy both a subjective and an objective test of “good faith.”

1. Honesty in Fact

Prior to the changes adopted by the Legislature in 1993, the holder in due course doctrine turned on a subjective standard of good faith and was often referred to as the “pure heart and empty head” standard. That standard merely required a holder to take an instrument with “honesty in fact” to become a holder in due course.

Courts interpreting this language have routinely declared banks to be holders in due course, notwithstanding the failures of these banks to investigate or hold otherwise negotiable instruments, when they took the instruments with no knowledge of any defects, defenses, or stop payment orders. This approach has been understood to promote the negotiability of instruments, particularly checks, in the stream of commerce. Rejecting a contrary approach, one court put it bluntly:

The requirement urged by defendant would bring the banking system to a grinding halt. A stop payment order issued by the drawer to the drawee which is unknown to the paying-collecting bank cannot fasten upon the paying bank any legal disability; particularly it cannot reduce the status of the collecting bank to a mere assignee of the instrument or a holder of a non-negotiable instrument, or a mere holder of a negotiable instrument.


Although courts were often urged to engraft an objective reasonableness standard onto the concept of “honesty in fact,” most refused to do so. Their refusals recognized that: “[T]he check is the major method for transfer of funds in commercial practice. The maker, payee, and endorsers of a check naturally expect it will be rapidly negotiated and collected. . . . The wheels of commerce would grind to a halt [if an objective standard were adopted].” _Bowling Green, Inc. v. State St. Bank & Trust_, 425 F.2d 81, 85 (1st Cir.1970).

Moreover, under the purely subjective standard, a bank was not expected to require the presence of offsetting collected funds in the customers’ account in order to give value on newly deposited checks: “A bank’s permitting its customers to draw against uncollected funds does not

Application of the “honesty in fact” standard to the Credit Union’s conduct here demonstrates these principles at work. It is undisputed that the Credit Union had no knowledge that Richard obtained the Sun Life checks by fraud. Nor was the Credit Union aware that a stop payment order had been placed on the Sun Life checks. The Credit Union expeditiously gave value on the checks, having no knowledge that they would be dishonored. In essence the Credit Union acted as banks have, for years, been allowed to act without risk to holder in due course status. The Credit Union acted with honesty in fact.

Thus, had the matter at bar been decided before the Legislature’s addition of the objective component of “good faith,” there can be little question that the Credit Union would have been determined to have been a holder in due course. Because it took the instruments without notice of any possible dishonor, defect, fraud, or illegality, it could have given value immediately and yet have been assured of holder in due course status. Today, however, something more than mere subjective good faith is required of a holder in due course.

2. Reasonable Commercial Standards of Fair Dealing

We turn then to the objective prong of the good faith analysis. The addition of the language requiring the holder to prove conduct meeting “reasonable commercial standards of fair dealing” signals a significant change in the definition of a holder in due course. While there has been little time for the development of a body of law interpreting this new objective requirement, there can be no mistaking the fact that a holder may no longer act with a pure heart and an empty head and still obtain holder in due course status. The pure heart of the holder must now be accompanied by reasoning that assures conduct comporting with reasonable commercial standards of fair dealing.

The addition of the objective element represents not so much a new concept in the doctrinal development of holder in due course status, but rather a return, in part, to an earlier approach to the doctrine. See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE§ 14–6, at 62829 (3d ed.1988) (discussing the objective test of good faith in England, first applied by the King’s Bench in Gill v. Cubitt, 3 B & C 466, 107 Eng. Rep. 806 (K.B.1824)). The concept of an objective component of good faith has been part of the discussion regarding the holder in due course doctrine since the first enactment of the U.C.C. See id. (noting that “[t]he good faith requirement has been the source of a continuing and ancient dispute”). The early drafters debated the need and wisdom of including such an objective component and ultimately determined not to include it in the definition of good faith because of its potential for freezing commercial practices.
Reiterated Anachronism, 21 U. TOL. L.REV. 625, 653–54 (1990)] (noting, in particular, the objection by the banking industry to the addition of an objective good faith component). The “new” element of good faith requiring the holder to act according to reasonable commercial standards of fair dealing is actually a more narrow version of the “reasonable person” standard considered and rejected by the drafters [of] the 1962 Code.

The new objective standard, however, is not a model of drafting clarity. Although use of the word “reasonable” in the objective portion of the good faith test may evoke concepts of negligence, the drafters attempted to distinguish the concept of “fair” dealing from concepts of “careful” dealing:

Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely different concept than failure to deal fairly in conducting the transaction.

Unfortunately, the ease with which the distinction between “fair dealing” and “careful dealing” was set forth in the comments to the U.C.C. revisions belies the difficulty in applying these concepts to the facts of any particular case, or in conveying them to a jury. The difficulty is exacerbated by the lack of definition of the term “fair dealing” in the U.C.C. 21 The most obvious question arising from the use of the term “fair” is: fairness to whom? Transactions involving negotiable instruments have traditionally required the detailed level of control and definition of roles set out in the U.C.C. precisely because there are so many parties who may be involved in a single transaction. If a holder is required to act “fairly,” regarding all parties, it must engage in an almost impossible balancing of rights and interests. Accordingly, the drafters limited the requirement of fair dealing to conduct that is reasonable in the commercial context of the transaction at issue. In other words, the holder must act in a way that is fair according to commercial standards that are themselves reasonable.

The factfinder must therefore determine, first, whether the conduct of the holder comported with industry or “commercial” standards applicable to the transaction and, second, whether those standards were reasonable standards intended to result in fair dealing. Each of those determinations must be made in the context of the specific transaction at hand. If the factfinder’s conclusion on each point is “yes,” the holder will be determined to have acted in good faith even if, in the individual transaction at issue, the result appears unreasonable. Thus a holder may be accorded holder in due

21. One commentator has suggested that fair dealing refers to “playing by the rules.” See [Patricia L. Heatherman, Comment, Good Faith in Revised Article 3 of the Uniform Commercial Code: Any Change? Should There Be?, 29 WILAMETTE L. REV. 567, 585 (1993)]. Yet “the rules” ordinarily define the parameters of reasonable conduct, a concept which sounds much like a negligence analysis.
course status where it acts pursuant to those reasonable commercial standards of fair dealing—even if it is negligent—but may lose that status, even where it complies with commercial standards, if those standards are not reasonably related to achieving fair dealing.

Therefore the jury’s task here was to decide whether the Credit Union observed the banking industries’ commercial standards relating to the giving of value on uncollected funds, and, if so, whether those standards are reasonably designed to result in fair dealing.

The evidence produced by the Credit Union in support of its position that it acted in accordance with objective good faith included the following: The Credit Union’s internal policy was to make provisional credit available immediately upon the deposit of a check by one of its members. In certain circumstances—where the check was for a large amount and where it was drawn on an out-of-state bank—its policy allowed for a hold to be placed on the uncollected funds for up to nine days. The Credit Union’s general written policy on this issue was reviewed annually—and had always been approved—by the National Credit Union Administration, the federal agency charged with the duty of regulating federal credit unions. See 12 U.S.C.A. § 1752a (Law.Co-op.1996). In addition, the policy complied with applicable banking laws, including Regulation CC. See 12 C.F.R. §§ 229.12(c), 229.13(b) (1998).

The Credit Union also presented evidence that neither Regulation CC nor the Credit Union’s internal policy required it to hold the checks or to investigate the genesis of checks before extending provisional credit. It asserted that it acted exactly as its policy and the law allowed when it immediately extended provisional credit on these checks, despite the fact that they were drawn for relatively large amounts on an out-of-state bank. Finally, the Credit Union presented expert testimony that most credit unions in Maine follow similar policies.

In urging the jury to find that the Credit Union had not acted in good faith, Sun Life and the Guerrettes argued that the Credit Union’s conduct did not comport with reasonable commercial standards of fair dealing when it allowed its member access to provisional credit on checks totalling over $120,000 drawn on an out-of-state bank without either: (1) further investigation to assure that the deposited checks would be paid by the bank upon which they were drawn, or (2) holding the instruments to allow any irregularities to come to light.

The applicable federal regulations provide the outside limit on the Credit Union’s ability to hold the checks. Although the limit on allowable holds established by law is evidence to be considered by the jury, it does not

22. The Credit Union could also have withheld provisional credit under the law and its own internal policy if there were other reasons to doubt the validity of the checks. See 12 C.F.R. § 229.13(e) (1998).
itself establish reasonable commercial standard of fair dealing. The factfinder must consider all of the facts relevant to the transaction. The amount of the checks and the location of the payor bank, however, are relevant facts that a bank, observing reasonable commercial standards of fair dealing, takes into account when deciding whether to place such a hold on the account. The jury was entitled to consider that, under Regulation CC, when a check in an amount greater than $5,000 is deposited, or when a check is payable by a nonlocal bank, a credit union is permitted to withhold provisional credit for longer periods of time than it is allowed in other circumstances. See 12 C.F.R. § 229.13(b), (h) (1998). Therefore, the size of the check and the location of the payor bank are, under the objective standard of good faith, factors which a jury may also consider when deciding whether a depositary bank is a holder in due course.

The Credit Union’s President admitted the risks inherent in the Credit Union’s policy and admitted that it would not have been difficult to place a hold on these funds for the few days that it would normally take for the payor bank to pay the checks. He conceded that the amount of the checks were relatively large, that they were drawn on an out-of-state bank, and that these circumstances “could have" presented the Credit Union with cause to place a hold on the account. He also testified to his understanding that some commercial banks followed a policy of holding nonlocal checks for three business days before giving provisional credit. Moreover, the Credit Union had no written policy explicitly guiding its staff regarding the placing of a hold on uncollected funds. Rather, the decision on whether to place a temporary hold on an account was left to the “comfort level” of the teller accepting the deposit. There was no dispute that the amount of the three checks far exceeded the $5,000 threshold for a discretionary hold established by the Credit Union’s own policy.

On these facts the jury could rationally have concluded that the reasonable commercial standard of fair dealing would require the placing of a hold on the uncollected funds for a reasonable period of time and that, in giving value under these circumstances, the Credit Union did not act according to commercial standards that were reasonably structured to result in fair dealing.

We recognize that the Legislature’s addition of an objective standard of conduct in this area of law may well have the effect of slowing the “wheels of commerce.” As one commentator noted:

23. There was evidence that, on the second business day after he deposited the checks, Paul Richard notified the Credit Union that there may have been a problem with his deposit.

24. The new definition of “good faith” has been forecasted by some to bring possible “undesirable changes” to the law of negotiable instruments. See Henry J. Bailey, New 1990 Uniform Commercial Code: Article 3, Negotiable Instruments, and Article 4, Bank
Historically, it was always argued that if negotiable instruments were to be usefully negotiable a subsequent holder should not have to investigate the transaction giving rise to the paper. The paramount necessity of negotiability has dominated thinking and legislation on negotiable instruments law. Drafts and promissory notes, it has been believed, must be able to change hands freely, without investigation beyond the face of the instrument, and with no greater requirement than the indorsement of the holder.

*Sinclair, supra,* at 630 (footnotes omitted). Notwithstanding society’s oft-cited need for certainty and speed in commercial transactions, however, the Legislature necessarily must have concluded that the addition of the objective requirement to the definition of “good faith” serves an important goal. The paramount necessity of unquestioned negotiability has given way, at least in part, to the desire for reasonable commercial fairness in negotiable transactions.

IV. Effect of Fraud Defense

A. The Guerrettes

Having failed to persuade the jury that it was a holder in due course, the Credit Union is subject to any defense of the Guerrettes or Sun Life “that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract,” 11 M.R.S.A. § 3–1305(1)(b), or any “claim of a property or possessory right in the instrument or its proceeds.” 11 M.R.S.A. § 3–1306. Generally, fraud, such as that perpetrated by Paul Richard and Steven Hall, may be the basis for both a valid defense, and a valid claim to the instrument itself.

Fraud is an affirmative defense to a contract. To prevail on their fraud defense, the Guerrettes were required to prove, by clear and convincing evidence, that a fraudulent or material misrepresentation induced them to transfer the proceeds of their father’s life insurance policy, in the form of the Sun Life checks, to Steven Hall and Paul Richard. In addition, they were required to prove they were justified in relying on the fraudulent misrepresentation. The parties’ stipulation that Hall and Richard fraudulently induced the Guerrettes to invest the checks in their company, HER, Inc., is sufficient to satisfy the Guerrettes’ burden on this issue. The Guerrettes are not liable to the Credit Union for their indorsement of the Sun Life checks.

B. Sun Life

Sun Life, however, may not raise the fraud as a defense to its liability on the instrument. Section 3–1305(3) provides generally that:

in an action to enforce the obligation of a party to pay [an] instrument, the obligor may not assert against the person entitled to enforce the

*Deposits and Collections, 29 Willamette L. Rev. 409, 415 (1993).*
instrument a defense, claim in recoupment or claim to the instrument (section 3–1306) of another person.

11 M.R.S.A. § 3–1305(3). Accordingly, a defense to liability on an instrument—such as fraud in the underlying transaction—raised by one party to an action may not be raised by another party to the action as its own defense to liability. Section 3–1305(3) provides, however, that “the other person’s claim to the instrument may be asserted by the obligor if the other person is joined in the action and personally asserts the claim against the person entitled to enforce the instrument.” Id. Therefore, only if the Guerrettes have made a claim to the instrument and are parties to the proceeding may Sun Life assert the fraud in defense of its own liability. See 11 M.R.S.A. 3–1305(3); First Nat’l Bank of Nocona v. Duncan Sav. & Loan Ass’n, 656 F.Supp. 358, 366 (W.D.Okla.1987), aff’d, 957 F.2d 775 (10th Cir.1992).

The Guerrettes, however, made no claim that they were entitled to possession of the instruments held by the Credit Union.25 Instead, they merely argued that they were not liable as indorsers of the checks held by the Credit Union as a result of the fraud. The issue of fraud was therefore raised by the Guerrettes as a defense to their liability as indorsers of the instruments. The Superior Court erred when it held that the issue of fraud had been raised as a “claim to the instruments.”

Therefore, Sun Life may not raise the fraud against the Guerrettes as a defense to its own liability. Because Sun Life raises no other relevant defenses, it is liable to the Credit Union as the drawer of the instruments, see 11 M.R.S.A. § 3–1414(2)(a), and we vacate that portion of the Superior Court’s judgment finding that Sun Life was not liable to the Credit Union.

QUESTIONS

1. In what way, when, and with whom did the Credit Union deal unfairly?

2. Because the Sun Life checks constituted a “large deposit,” aggregating more than $5,000 on any one banking day, the normal Reg CC funds-availability schedules did not apply. Rather, the Credit Union was obligated to make the funds available not later than a “reasonable period” after the time set by the normal availability schedules. Reg CC 229.13(h)(2). With respect to the Sun Life checks, Reg CC would have allowed a nine-day hold period; however, “[a] longer extension may be reasonable, but the bank has the burden of so establishing.” Reg CC 229.13(h)(4). Could the Credit Union have met this burden?

25. The Guerrettes were issued new checks for the same amounts by Sun Life after Sun Life stopped payment on the original instruments.
3. The Credit Union also could have imposed a nine-day hold period if it had “reasonable cause to believe that the check is uncollectible from the paying bank.” Reg CC 229.13(e). According to the Regulation, “Reasonable cause to believe a check is uncollectible requires the existence of facts that would cause a well-grounded belief in the mind of a reasonable person.” Did the Credit Union have reasonable cause to believe the Sun Life checks were uncollectible?

4. In Chapter 1, Section 2, we discussed the two-pronged standard of “good faith” in Article 3. There we observed that the Comments to Section 205 of the Restatement (Second) of Contracts appear to link honesty with good faith purchase and fair dealing with good faith performance. Does it make sense to have a purchaser’s status as a holder in due course depend on fair dealing?

NOTE ON ADVERSE CLAIMS

Part IV of Maine Family Federal discusses the defense of fraud. Relying on the parties’ stipulation that Hall and Richard fraudulently induced the Guerettes to invest the checks in their company, the court held that the Guerettes had a good defense to their UCC 3–415 obligation as indorsers. Sun Life, however, could not raise the defense of fraud.

The general rule in UCC 3–305(c), as it applies to defenses and claims in recoupment, seems rather obvious. Of course an obligor may not assert against a person entitled to enforce the instrument another person’s defense or claim in recoupment. The fact that the Guerettes were defrauded and don’t have to pay doesn’t excuse Sun Life, which wasn’t defrauded, from paying. The general rule also applies to the assertion of another person’s “claim to the instrument (Section 3–306).” But UCC 3–305(c) provides for circumstances under which an obligor may assert against a PETETI another person’s claim to the instrument: if the other person is joined in the action and personally asserts the claim against the PETETI.

When might one person assert another’s claim to the instrument? UCC 3–305, Comment 4, suggests that the rule applies principally to cases in which an obligation is paid with the instrument of a third person. Consider this scenario: Suppose Quaker was defrauded into indorsing and delivering the check to one of its suppliers, Fraud. Quaker discovers the fraud and notifies Empire, which stops payment. The check is dishonored and returned to Fraud, who, as the PETETI, sues Empire, as drawer, under 3–414. Quaker, not Empire, has been defrauded. Empire cannot raise Quaker’s defense of fraud. But Quaker has a better claim to the check than does Fraud. See UCC 3–202(b) (indicating that a negotiation generally may be rescinded to the extent permitted by non-UCC law); UCC 3–306 (providing that a person without the rights of an HDC takes subject to a claim to rescind a negotiation and recover the instrument). As between
Quaker and Fraud, Quaker should enjoy the right to enforce Empire’s obligation on the check.

UCC 3–305(c) permits Empire to defend on this basis—“the other person’s [Quaker’s] claim to the instrument may be asserted by the obligor [Empire]”—but only “if the other person [Quaker] is joined in the action and personally asserts the claim against the person entitled to enforce the instrument [Fraud].” By ensuring that the adverse claimant (Quaker, whose claim is adverse to Fraud’s) is a party to any suit in which its rights are determined, the UCC prevents the relitigation of identical issues in subsequent actions, such as an action brought by Quaker against Fraud. It also minimizes the possibility that Fraud might be unjustly enriched if it recovers from Empire but Quaker does not assert its adverse claim.

Comment 4 to UCC 3–305 suggests a more common scenario in which an obligor on an negotiable instrument might assert jus tertii (the rights of a third person): When the person entitled to enforce a cashier’s check has acquired it by defrauding the payee.