

THE UNIFORM COMMERCIAL CODE'S UNDOING OF AN OBLIGATION

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Under the provisions of the Uniform Commercial Code,¹ a party who is secondarily liable on negotiable paper can be discharged from his liability on that paper by an act of a holder. An example of such an act is failure to make necessary presentment or to give notice of dishonor at the time when the instrument is due.² According to the language of section 3-802(1)(b) of the Code,³ such discharge of a secondarily-liable party from his liability on the instrument will also discharge him from his liability for the underlying obligation for which the instrument was given. The thesis of this article is that such a result may be both unjust and unnecessary in commercial practice. For example, consider the case of the indorser of a check who gives that check to a merchant in payment for goods purchased. He will be discharged (absent warranty considerations) both from his liability on the check and his liability to pay for the goods by an unexcused failure of the merchant to either make timely and necessary presentment for payment or to give notice of dishonor. If the drawer, unknown to either the indorser or the merchant, was insolvent when the check was drawn, is there any reason why the indorser should be discharged, since he would not have been able to collect from the drawer upon timely presentment for payment and notice of dishonor? Should the fact of the existence of an intermediate indorser affect the answer to this question? This article explores the ramifications of these thought-provoking questions. Such an investigation requires an analysis of the liability of parties on negotiable paper.

I. LIABILITY OF THE PARTIES TO A NEGOTIABLE INSTRUMENT

In essence, the issue relates to the methods of recovery open to the holder of an indorsement-bearing check other than relief based on the instrument itself. In other words, it relates to relief based on the

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¹ U.C.C. § 3-802.

(1) Unless otherwise agreed where an instrument is taken for an underlying obligation (a) the obligation is pro tanto discharged if a bank is drawer, maker or acceptor of the instrument and there is no recourse on the instrument against the underlying obligor; and (b) in any case the obligation is suspended pro tanto until the instrument is due or if it is payable on demand until its presentment. If the instrument is dishonored action may be maintained on either the instrument or the obligation; discharge of the underlying obligor on the instrument also discharges him on the obligation.

² U.C.C. § 3-502(1)(a) (where such failure is without excuse).

³ Supra note 1.

underlying obligation; in the example above, the obligation arising from the purchase of goods. In order to consider fully the available methods of recovery, the reader must draw an initial distinction between a person's liability as a party to the negotiable instrument, and his liability arising from the obligation for which the negotiable instrument was given. The former can be considered "liability on the instrument," and the latter "liability for the underlying obligation." Since the Code provides that "discharge of the underlying obligor on the instrument also discharges him on the obligation,"⁴ it is necessary to examine first his "liability on the instrument." Then, an examination of the relationship between the two obligations will reveal the effect of the section quoted above.

For purposes of this article three types of liability on the instrument will be predicated—primary, intermediate (a term not used by the draftsmen of the Uniform Commercial Code) and secondary. "Primary liability" exists where a party's liability is fixed without the necessity of satisfying conditions precedent, such as a demand for payment. The phrase "intermediate liability" is used by this author to denote that type of liability by which a holder is subject to the operation of conditions precedent such as presentment for payment and notice of dishonor, but in which failure to observe the conditions precedent only results in discharging the party to whom the conditions run to the extent of the latter's injury.⁵ Intermediate liability indicates a "no harm—no discharge" rule. Thus, although intermediate liability may be designated under the various provisions of the Code as "primary" or "secondary" liability, it is used in this article to represent the special situation of any drawer or acceptor of a draft payable at a bank or maker of a note payable at a bank when bank insolvency occurs.⁶ "Secondary liability," on the other hand, exists when failure to observe conditions precedent results in total discharge of a party from liability on the instrument. The purpose of using the two latter terms is to draw into sharp distinction the preferred treatment given to a person secondarily liable, an indorser, in comparison with one who is intermediately liable, any drawer who maintains funds with the drawee and is injured by the drawee's insolvency.

A brief analysis of these three types of liability and a number of comparisons among the Uniform Commercial Code (U.C.C.), the Negotiable Instruments Law (N.I.L.), and the Law Merchant will illustrate these distinctions. For the purpose of describing the types of liability, the parties to a negotiable instrument will be considered

⁴ U.C.C. § 3-802(1)(b).

⁵ U.C.C. § 3-502(1)(b). The conditions of intermediate liability are laches, funds maintained with the drawee and subsequent insolvency, and written assignment.

⁶ U.C.C. § 3-501(1)(b).

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as (1) parties primarily liable, makers of notes and acceptors of drafts; (2) parties intermediately liable, drawers of checks and drafts; and (3) parties secondarily liable, indorsers.

A. *Primary Liability*

1. *Makers of Notes*

Under the Code, the maker of a note can be discharged only by payment, cancellation,⁷ real defenses,⁸ or the running of the statute of limitations.⁹ Hence, there are no conditions precedent to his liability—he is “primarily liable.”¹⁰ Accordingly, the maker will not be discharged from his liability on the instrument or his liability for the underlying obligation for failure of the conditions precedent under the provisions of section 3-802(1)(b) of the Code. Therefore, further consideration of the maker of a note is unnecessary for purposes of this article.

The Code engrafts an exception upon the primary liability of the maker in the case of a bank domiciled note. The maker of a note payable at a bank is only intermediately liable if the payor bank becomes insolvent during the laches of a holder. Under such circumstances, the maker may discharge his liability by assigning his rights against the payor bank in those funds to the holder, but the maker is not otherwise discharged.¹¹ Dean Hawkland considers this exception to be just, for an imposition of the risk of bank insolvency on the obligor “could seriously impair the use of domicile paper, especially in times of recession or depression.”¹² The importance of this exception to section 3-802(1)(b) is that the maker of a bank domiciled note will be afforded intermediate liability only when (1) the laches of the holder occurs during a bank’s insolvency, and (2) the maker assigns his claim against the bank to the holder. Thus, a “no harm—no discharge” rule is adopted.

2. *Acceptors of Drafts*

The acceptance of a draft binds the acceptor to primary liability.¹³ After acceptance, the acceptor, like the maker of a note, will not be

⁷ See U.C.C. § 3-605.

⁸ See U.C.C. § 3-601.

⁹ A cause of action against a maker (acceptor) accrues in the case of a time instrument on the day after maturity, and in the case of a demand instrument upon its date or if no date is stated, on the date of issue. U.C.C. § 3-122. A cause of action against the obligor of a demand or time certificate of deposit accrues upon demand, but demand on a time certificate may not be made until on or after the date of maturity. U.C.C. § 3-122(2).

¹⁰ Difficulty may arise in determining who is the maker. See generally Hawkland, *Commercial Paper* 29-38 (1959).

¹¹ U.C.C. § 3-502(1)(b). See also U.C.C. § 3-121 as to bank’s duty and function.

¹² Hawkland, *supra* note 10, at 26.

¹³ U.C.C. §§ 3-410(1), -413(1).

discharged on the instrument for failure to observe conditions precedent. Therefore, aside from possible variations in the statute of limitations, there is no difficulty caused by questions of whether conduct by the holder of an instrument will discharge the acceptor on the underlying obligation.

B. *Intermediate Liability*

1. *Drawers of Checks*

The Code provides for situations where necessary presentment or notice of dishonor is delayed, without excuse, beyond the time when it is due. In such cases, any drawer of a check payable at a bank (or of a bank domiciled draft payable at a specified time), who is deprived of funds he maintained at the bank because it became insolvent during the delay, may discharge his liability to the holder by written assignment to the holder of his rights to those funds against the bank; but the drawer (or the acceptor or maker) "*is not otherwise discharged.*"¹⁴ (Emphasis added.) Since presentment for payment,¹⁵ notice of dishonor and necessary protest¹⁶ are conditions precedent to the drawer's liability, his liability is intermediate and he will be discharged only when he is injured due to bank insolvency. For the Code to become operative, there must be both an unexcused delay and an intervening insolvency.¹⁷ In establishing the liability of a drawer, presentment of an uncertified check within thirty days of its date, or the date of issue, whichever is later, is presumed presentment within a reasonable time.¹⁸ Consequently, if the check becomes "stale," an unexcused delay will effect discharge to the extent of injury occasioned by bank insolvency. Otherwise the "no harm—no discharge" rule applies, and the drawer of an uncertified check will remain liable on both the instrument and the underlying obligation.¹⁹

Section 186 of the Negotiable Instruments Law provides that "a check must be presented for payment within a reasonable time after its issue or the drawer will be discharged from liability thereon to the extent of the loss caused by the delay." The difficulty with this section is that it is sometimes impossible to determine the precise amount of the loss caused until after liquidation of the bank. Further, the weight

¹⁴ U.C.C. § 3-502(1)(b).

¹⁵ A check is a demand instrument, and presentment for acceptance is not ordinarily necessary. But see U.C.C. § 3-501 (when instrument requires presentment).

¹⁶ This is only "necessary to charge the drawer and indorsers of any draft which on its face appears to be drawn or payable outside of the states and territories of the United States and the District of Columbia." U.C.C. § 3-501(3).

¹⁷ The provisions concerning waiver or excused presentment, found in U.C.C. § 3-511, are presumed inapplicable for purposes of this article.

¹⁸ U.C.C. § 3-503(2)(a).

¹⁹ See U.C.C. § 4-404 (bank under no obligation to pay after six months).

of authority interpreting the section places the burden of proof on the maker or drawer to establish his loss.²⁰ The U.C.C. resolves this problem by use of the assignment procedure,²¹ while the N.I.L. requires presentment for payment as a condition precedent to charging the drawer or indorser.²² Reasonable time is defined by section 71 of the N.I.L. as being "within a reasonable time after the last negotiation thereof," and since the statute "puts no limit on the length of time that presentment for payment may be delayed provided only that it is made within a reasonable time after the last negotiation [assuming timely intermediate negotiations] . . .," it has engendered no little difficulty.

Commenting on the obligation of the drawer of a check on the underlying obligation under the Code, Professor Farnsworth states that "in UCC 3-802 the usual rule that a check is conditional payment is restated in more helpful terms of suspension of the underlying obligation."²³ Although the doctrine of "conditional payment" will be discussed in some detail hereinafter, it is important to note that he refers to the provision that the underlying obligation is "pro tanto discharged" until dishonor at which time an action may be maintained on either the instrument or the underlying obligation.²⁴ Even though "pro tanto" is normally used to mean "for so much,"²⁵ the Code's draftsmen appear to be using it to mean that the underlying obligation is merged with the obligation on the instrument. Thus, where the bank has not been shown to be insolvent, the drawer of a check is not discharged from the instrument and is still liable on the underlying obligation as well.

2. *Drawers of Drafts*

The rule adopted for drawers of checks applies as well to drawers of drafts under the Code, which speaks in terms of "*any* drawer." (Emphasis added.) Presentment for payment,²⁶ notice of dishonor,²⁷ and presentment for acceptance are necessary to charge the drawer. This last condition is required only where (1) the draft itself so provides, or (2) it is payable elsewhere than at the drawer's residence or place of business or (3) the date of payment depends on presentment.²⁸

²⁰ *Mars, Inc. v. Chubrito*, 216 Wis. 313, 257 N.W. 157 (1934) (action on account, defense check payment due to laches) and cases cited therein.

²¹ U.C.C. § 3-502(1)(b).

²² N.I.L. § 70. Presentment for acceptance, notice of dishonor and protest may also be required. N.I.L. § 89.

²³ Farnsworth, *Negotiable Instruments* 55 (1959).

²⁴ U.C.C. § 3-802(1)(b).

²⁵ *Black, Law Dictionary* 1364 (4th ed. 1951).

²⁶ U.C.C. § 3-501(1)(c).

²⁷ U.C.C. § 3-501(2)(b).

²⁸ U.C.C. § 3-501(1)(a).

Failure to give notice of dishonor discharges the drawer²⁹ only in a case where the drawee maintains funds of the drawer and an insolvency situation ensues, "but such drawer is not otherwise discharged."³⁰ Although the Code labels him a "secondary party,"³¹ the drawer has the status of intermediate liability, since (1) his liability is subject to conditions precedent and (2) he can be discharged only where he has been injured (assuming there has been compliance with Code provisions). The significance of this status and its effect on the drawer's liability for the underlying obligation can be better understood by comparing the positions of drawers and indorsers under the U.C.C. with their positions under the N.I.L.

Since the N.I.L. equates primary liability with an absolute obligation to pay, the drawer of a draft is secondarily liable³² because presentment for acceptance³³ or presentment for payment³⁴ is required to raise such an obligation in him. Difficulties arise, however, when the courts are faced with functional evaluations of drafts and checks.

Under an older theory, laches of the creditor discharges the drawer on both the instrument and the underlying obligation, whether or not the latter has suffered injury as a result.³⁵ On the other hand, the drawer of a check is discharged only to the extent of the loss caused by the delay.³⁶ An anomalous situation thus arises: when the creditor's delay does not amount to laches, but is merely a negligent delay in seeking his remedies, and the draft is not accepted, no one is primarily liable on the instrument. Not only is the drawer discharged from the instrument, but he is released from the underlying obligation as well! Accordingly, the drawer of a check is held to greater liability than the drawer of a draft, i.e., "the drawer of a check is not, in the fullest sense, a secondary party. Nor is he a primary party . . . [he] occupies a position intermediate between that of a primary party and that of a secondary party."³⁷

An examination of the functions of a draft indicates that it is used as a short term credit and collection instrument as well as an instrument used to transmit funds. Unlike the drawer of a check, who may have criminal sanctions imposed where he does not have funds in the

²⁹ U.C.C. §§ 3-501(1)(c), (2)(b). But see U.C.C. § 3-511 (notice excused).

³⁰ An assignment of the claim is necessary to effect discharge. U.C.C. § 3-502(1)(b).

³¹ U.C.C. § 3-501(1).

³² N.I.L. § 192.

³³ N.I.L. §§ 143-44, 150.

³⁴ N.I.L. § 70.

³⁵ Cases illustrating this theory are *Minehart v. Handlin*, 37 Ark. 276 (1881); *Phoenix Ins. Co. v. Allen*, 11 Mich. 501 (1863); *Shipman v. Cook*, 16 N.J. Eq. 251 (Ch. 1863); *Allan v. Eldred*, 50 Wis. 132, 6 N.W. 565 (1880).

³⁶ N.I.L. § 186.

³⁷ Britton, *Bills & Notes* § 199, at 872 (1943).

drawee bank's possession to cover the check,³⁸ a drawer of a draft does not usually draw "on funds." In a check situation, the holder who is guilty of laches has no standing to complain when, during his laches, the drawer, who maintained funds with the drawee, is injured.³⁹ Even though the relationship of the drawer of a draft and the drawee is presumably contractual,⁴⁰ the results under the statutes are by no means consistent. Under the N.I.L., the drawer of a draft can be discharged from the instrument where the holder has failed to observe conditions precedent to his liability. The Code apparently allows two results: (1) under certain circumstances, where the drawer of a draft has funds maintained with a drawee, he can be discharged to the extent of his injury by the holder's failure to observe conditions precedent; and (2) conversely, where the drawer has no funds maintained with a drawee, he cannot be discharged from the instrument. In either case, however, the minimal liability of the drawer of a draft under the Code is intermediate since his discharge will be only to the extent of his injury.

Comparison of a drawer of a draft with an indorser of a note under the Code is worthy of discussion with respect to the distinction between intermediate and secondary liability. Under the Law Merchant, an indorser was considered a new drawer;⁴¹ however, his status changed under the N.I.L. and the Code.⁴² Under the N.I.L., both the drawer of a draft and the indorser of a note are "secondarily liable"⁴³ and neither party makes an unconditional promise to pay.⁴⁴ There are distinctions in the N.I.L. between the secondary liability of the drawer of a draft and that of an indorser of a note. For example, to charge the indorser, presentment for payment must be made within a reasonable time after the *last negotiation*, but to fix the liability of the drawer of a draft, it must be within a reasonable time after *issue*.⁴⁵ Some courts have simply refused to equate the parties on the basis of this distinction.⁴⁶ The most significant difference between the two parties arises in regard to the liability of each for the underlying obligation. While the courts have applied the "check rule" to the indorser of

³⁸ Hawkland, *supra* note 10, at 41.

³⁹ *Ibid.*

⁴⁰ Britton, *supra* note 37, § 199, at 872.

⁴¹ *Ballingalls v. Gloster*, 3 East 481, 102 Eng. Rep. 681 (K.B. 1803).

⁴² N.I.L. § 192; U.C.C. § 3-501(1)(c).

⁴³ N.I.L. § 192.

⁴⁴ The indorser of a note does not unconditionally promise to pay it, nor does the drawer of a draft. By negotiating the instrument, the indorser orders the maker to pay to the bearer or to the order of the indorsee. Similarly the drawer orders the drawee to pay to the bearer or order of the indorsee.

⁴⁵ N.I.L. § 71.

⁴⁶ *Winnebago County State Bank v. Hustel*, 119 Iowa 115, 93 N.W. 70 (1903) (no authority in which drawer and payee are treated as synonymous).

a promissory note and refused to release him on the underlying obligation unless the laches of the creditor-holder has injured him, laches of the creditor-holder has released the drawer of a draft on the underlying obligation whether or not he has been injured.⁴⁷

The Code has approached this problem through the contractual liability of the parties. By increasing the drawer's liability on the instrument, and allowing discharge to the extent of injury, the Code has increased his liability on the underlying obligation in cases where no injury has occurred. Even though the Code holds the drawer of a draft to a "no harm—no discharge" rule, it has reversed the N.I.L. as to "any indorser" by allowing discharge from liability on the underlying obligation upon discharge on the instrument.⁴⁸ In other words, the drawer of a draft will be held to his underlying obligation where he has not been "deprived of funds" by the drawee's insolvency,⁴⁹ but injury plays no part in the release of the indorser from his underlying obligation.

C. Secondary Liability

Presentment for payment and notice of dishonor are necessary to charge a secondary party, any indorser.⁵⁰ Where either necessary presentment or notice of dishonor is delayed without excuse beyond the time when due, *any* indorser is discharged on the instrument.⁵¹ Since any indorser will be discharged on the instrument if the holder fails to observe the conditions precedent, his liability is "secondary" by definition.⁵² The Code draws no distinction, other than what constitutes a reasonable time for presentment,⁵³ among indorsers of notes, checks and drafts.

Dean Hawkland suggests⁵⁴ that the liability of a secondary party

⁴⁷ Where creditor's laches has discharged the drawer on the instrument and underlying obligation whether or not injury resulted, see cases cited note 35 *supra*. For cases holding discharge only where injury (which in the absence of proof is presumed), see *McCrary v. Carrington*, 35 Ala. 698 (1860); *Smith v. Miller*, 52 N.Y. 545 (1873). For cases holding no release unless injury proven, see *Dow v. Cowan*, 23 F.2d 646 (8th Cir. 1927); *Commercial Inv. Trust v. Lundgren-Wittensten Co.*, 173 Minn. 83, 216 N.W. 531 (1927).

⁴⁸ "Where without excuse any necessary presentment . . . is delayed beyond the time when it is due (a) any endorser is discharged [on the instrument] . . ." U.C.C. § 3-502(1)(a). "[D]ischarge of the underlying obligor on the instrument also discharges him on the obligation." U.C.C. § 3-802(1)(b).

⁴⁹ Note that U.C.C. § 3-502, Comment 2 states that "where bank failure or other insolvency of the drawee or payor has prevented him from receiving the benefit of funds," the drawer (acceptor or maker) is "deprived of funds." However, this would not include a situation where the drawer was insolvent.

⁵⁰ U.C.C. § 3-501(1)(b).

⁵¹ U.C.C. § 3-502(1)(a).

⁵² "Secondary liability . . . exists when failure to observe conditions precedent results in total discharge. . . ." *Supra* p. 64.

⁵³ U.C.C. § 3-503.

⁵⁴ Hawkland, *supra* note 10, at 39.

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may be predicated on three different theories: (1) on the indorser or drawer contract, (2) on the warranty contract, and (3) on the underlying obligation. For the purpose of this article, the engagement of the indorser⁵⁵ and the conditions precedent necessary to charge him with liability on the instrument are outlined in a footnote,⁵⁶ as are the warranties given by the indorser.⁵⁷

Our primary purpose is to consider the liability of a secondary party based on the underlying obligation. Since, pursuant to section 3-502(1)(a) of the Code, an unexcused delay of necessary presentment will discharge any indorser from his liability on the instrument, the discharge will also affect his liability on the underlying obligation under the provisions of section 3-802(1)(b).⁵⁸ The Code provides in substance that, in establishing the liability of any secondary party, presentment of an instrument is due within "a reasonable time after such party becomes liable thereon."⁵⁹ Although it does not precisely

⁵⁵ Where there is no written disclaimer, every indorser engages to any holder (whether or not for value) and to subsequent indorsers that he will pay the instrument according to its tenor at the time of his indorsement where the conditions precedent, i.e., presentment for payment, dishonor, necessary notice of dishonor and protest, have been met. U.C.C. § 3-414(1).

⁵⁶ Compare U.C.C. §§ 3-501(1)(a), -506, with N.I.L. §§ 143-51 (presentment for acceptance). Compare U.C.C. §§ 3-501(1)(b), -506, with N.I.L. §§ 70-86 (presentment for payment). Compare U.C.C. § 3-504(2), with N.I.L. §§ 72-74 (payment) and N.I.L. § 145 (acceptance) as to how presentment is made. Compare U.C.C. § 3-504(4), with N.I.L. § 75 (bank domiciled instruments). Compare U.C.C. § 3-505(1)(a)-(d), with N.I.L. § 74 (rights of a party to whom presentment is made).

Compare U.C.C. § 3-501(2)(a),(b), with N.I.L. § 89 (necessity of notice of dishonor). Compare U.C.C. § 3-508, with N.I.L. § 89 (to whom notice is given). Compare U.C.C. § 3-508, with N.I.L. §§ 90-92 (by whom notice is given). Compare U.C.C. § 3-508(2), with N.I.L. §§ 102-04, 107 (definition of when notice is due). Compare U.C.C. § 3-508(3)-(8), with N.I.L. §§ 95, 96 (how notice is given).

Compare U.C.C. § 3-509, with N.I.L. §§ 118, 152-60 (definition of protest). Compare U.C.C. § 3-501(3), with N.I.L. § 152 (when protest is necessary). Compare U.C.C. § 3-509(1),(2), with N.I.L. § 153 (how protest is made). Compare U.C.C. § 3-509(1), with N.I.L. § 154 (by whom protest is made).

⁵⁷ This discussion avoids the issue of waiver of conditions precedent. *Supra* note 17. However, the appropriate Uniform Commercial Code and Negotiable Instruments Law sections concerning waiver should be considered prior to discharge. The Negotiable Instruments Law establishes five types of waiver: (1) "not required," N.I.L. §§ 79-80, 114-15; (2) "excused," N.I.L. §§ 81, 83(2), 113; (3) "dispensed with," N.I.L. §§ 82, 112; (4) "not necessary," N.I.L. § 116; and (5) "waived," N.I.L. §§ 82(3), 109-11. The Uniform Commercial Code simplifies this into two categories: (1) "temporarily excused," U.C.C. § 3-511(1); and (2) "entirely excused," U.C.C. § 3-511(2). Presentment may be entirely excused under U.C.C. § 3-511(2)(a) (waived by the party to be charged); U.C.C. § 3-511(2)(b) (party has dishonored himself); U.C.C. § 3-511(2)(c) (presentment cannot be made); U.C.C. § 3-511(3)(a) (death); U.C.C. § 3-511(3)(b) (refused other than for want of proper presentment); U.C.C. § 3-511(4) (prior non-acceptance); and U.C.C. § 3-511(5) (waiver of protest). Cf. U.C.C. § 3-511(6) (waiver written on instrument).

⁵⁸ "If the instrument is dishonored action may be maintained on either the instrument or the obligation; discharge of the underlying obligor on the instrument also discharges him on the obligation." U.C.C. § 3-802(1)(b).

⁵⁹ U.C.C. § 3-503(1)(e).

define "reasonable time," it establishes guide lines such as the nature of the instrument, and the usages of banking or trade.⁶⁰ In the case of an uncertified check, the presumption is that "reasonable time" in regard to a drawer is thirty days after its date or the date of issue, whichever is later;⁶¹ and in regard to an indorser it is seven days after his indorsement.⁶²

While there is a split of authority under the N.I.L. as to whether an indorser of a promissory note is discharged on his underlying obligation only to the extent that the laches of his creditor-holder has injured him, the courts in most states hold that the indorser of a draft or check is discharged on the underlying obligation by a holder's laches.⁶³ In order to ascertain why any indorser should be released not only on the instrument but on the underlying obligation for which the instrument was given, it is necessary to examine the relationship between the two obligations.

In summary, under the Uniform Commercial Code, makers of notes and acceptors of drafts have primary liability. Therefore, a holder would not be precluded from looking to a maker or acceptor on the instrument should there be a failure to observe the conditions precedent necessary to charge parties who are "intermediately" or "secondarily" liable. This eliminates the necessity of considering a maker's or acceptor's liability on the underlying obligation in this discussion. The drawer of a check or draft, or the maker of a bank domiciled note, is inter-

⁶⁰ U.C.C. § 3-503(2).

⁶¹ U.C.C. § 3-503(2)(a).

⁶² U.C.C. § 3-503(2)(b).

⁶³ Where indorser is discharged on the underlying obligation, see *McCrary v. Carrington*, supra note 47 (dictum) (third party instrument); *Nixon v. Beard*, 111 Ind. 137, 12 N.E. 131 (1887) (note taken from pre-existing indebtedness discharges surety); *Orange Screen Co. v. Holmes*, 103 N.J.L. 560, 138 Atl. 105 (Sup. Ct. 1927) (indorser discharged for holder's laches); *Shipman v. Cook*, supra note 35 (indorser discharged for holder's laches); *Dibble v. Richardson*, 171 N.Y. 131, 63 N.E. 829 (1902) (third party instrument taken); *Cohen v. Rossmore*, 225 App. Div. 300, 233 N.Y.S. 196 (1929) (surety released where not on renewal note); *Hall v. Green*, 14 Ohio 499 (1846) (indorser discharged for laches of holder). For cases holding indorser not discharged on underlying obligation, see *Newell v. Newell*, 213 Ind. 261, 12 N.E.2d 344 (1938) (consideration for pre-existing debt or third party instrument); *Bradway v. Groenendyke*, 153 Ind. 508, 55 N.E. 434 (1899) (third party note); *Droege v. Hoagland State Bank*, 86 Ind. App. 236, 156 N.E. 592 (1927) (surety not discharged where renewal note forged); *Beech & Fuller Co. v. Lane*, 75 Ind. App. 184, 129 N.E. 52 (1920) (renewal note); *Kimmel v. State*, 75 Ind. App. 168, 128 N.E. 708 (1920) (surety not discharged where note was collateral security); *Emerine v. O'Brien*, 36 Ohio St. 491 (1881) (surety not released by forged indorsement on renewal note); *City of Philadelphia v. Neill*, 211 Pa. 353, 60 Atl. 1033 (1905) (dictum) (third party note); *United States v. Hegeman*, 204 Pa. 438, 54 Atl. 344 (1903) (renewal note taken); *City of Philadelphia v. Stewart*, 195 Pa. 309, 45 Atl. 1056 (1900) (third party note taken); *American Nat'l Bank v. National Fertilizer Co.*, 125 Tenn. 328, 143 S.W. 597 (1911) (third party note taken but holder not guilty of laches).

mediately liable, since, although there are conditions precedent to his liability which may effect a discharge on the instrument, no discharge on the underlying obligation will arise unless the drawer is prejudiced. Accordingly, consideration of the drawer's liability for the underlying obligation can be limited to those situations where the drawer has been injured by an act of a holder. Finally, since indorsers, who are secondarily liable under the Code, can be totally discharged from the instrument and the underlying obligation as well, it is necessary to investigate their relationship to both.

II. RELATIONSHIP OF LIABILITY ON THE INSTRUMENT TO LIABILITY ON THE UNDERLYING OBLIGATION

The relationship of liability on the instrument to liability for the underlying obligation is best illustrated by two negotiable instruments concepts, "conditional payment" and "merger." Where a payment is termed "conditional," it means, under the common law, that even though a creditor took a negotiable instrument, the original debt still existed, and the underlying obligation was not extinguished.⁶⁴ Conditional payment is defined by the Code as meaning that "taking the instrument is a surrender of the right to sue on the obligation until the instrument is due, but if the instrument is not paid on due presentment the right to sue on the obligation is 'revived.'"⁶⁵

The notion underlying the merger doctrine is that an initial obligation between the parties to a transaction is "merged" with the obligations arising out of a payment by a negotiable instrument from which new obligations flow. For example, "when a bill or note is taken for or on account of a debt, the question arises whether it was taken in absolute discharge of it, and operates as a complete merger. . . ."⁶⁶ Two types of merger deserve consideration, "absolute merger" and "partial merger." The former arises when a negotiable instrument is given for a debt, and the instrument is paid. The latter arises, using the same example, when a subsequent act by a holder causes the merger of the instrument and underlying obligation to be severed. Like so many statements in law, confusion arises not in the definition, but in its application.

⁶⁴ Kessler, Levi & Ferguson, *Some Aspects of Payment by Negotiable Instrument: A Comparative Study*, 45 *Yale L.J.* 1373, 1375 (1936).

⁶⁵ U.C.C. § 3-802, Comment 3. However, conditional payment refers to contractual relations and discharge on the instrument. It does not refer to discharge on the underlying obligation which is referred to as "absolute payment," i.e. where a negotiable instrument is taken for an underlying obligation and the "merger" is permanent, the negotiable instrument is an absolute payment of the underlying obligation. For discussion of merger, see pp. 82-85 *infra*.

⁶⁶ 3 Daniel, *Negotiable Instruments* § 1447, at 1490 (7th ed. 1933).

A. *The Concept of "Conditional Payment"*

The cases treating negotiable instruments as conditional payment break down into at least five categories: (1) cases attempting to distinguish between instruments taken as conditional payment from those taken as *collateral security*, (2) judicial analysis based on the *intent of the parties*, (3) judicial use of *presumptions* turning on the type of instrument taken, (4) questions of whether the instrument was taken for a *pre-existing* or *contemporaneous debt*, and (5) questions of whether the instrument was taken as *accord and satisfaction* of a debt.⁶⁷

1. *Instruments as Conditional Payment as Distinguished from Collateral Security*

In actions involving promissory notes, a split of authority has developed on the question of whether an indorser would be released on the underlying obligation if he were discharged on the promissory note.⁶⁸ Ordinarily, whether the holder took the negotiable paper as conditional payment or as collateral security for the debt would not affect the result. However, under one view, the rule was that failure to present a note for payment and to give notice of dishonor, thereby discharging an indorser, did not apply to a note given as collateral security.⁶⁹ For example, where the maker of a promissory note pledged the note of another person for a larger amount as collateral security, and the pledgee failed to demand payment of the note held as collateral, thereby discharging the indorser, the maker could not set up the discharge as a defense of payment in a suit on the first note.⁷⁰ The basis for this view was that (1) the parties expected the original debt to be discharged without resort to the collateral, (2) where collateral was involved, the debtor was expected to make the first move to discharge the debt, (3) where negotiable paper was given as collateral, the debt would ordinarily mature before the paper, and (4) collateral paper might be held by the creditor as an ordinary pledge without indorsement. However, the language used by the courts does not expressly distinguish collateral security from conditional payment.⁷¹ The doctrine of collateral security seems to have its roots in the

⁶⁷ In turn, the five categories will bear analysis by the circumstances of the case, and the functional use of the particular instrument.

⁶⁸ See note 63 *supra* and accompanying text.

⁶⁹ *Coleman v. Lewis*, 183 Mass. 485, 67 N.E. 603 (1903), *Kane v. Eastman*, 288 Pac. 819, 822 (Cal. App. 1930), and 68 L.R.A. 482 n.1 (1905) draw a distinction between "conditional payment" and "collateral security." *Contra*, *American Nat'l Bank v. National Fertilizer Co.*, *supra* note 63 (no distinction between the two phrases).

⁷⁰ *Coleman v. Lewis*, *supra* note 69. *Contra*, *Jennison v. Parker*, 7 Mich. 355, 360 (1859) (creditor makes draft his own by laches).

⁷¹ E.g., *Morris & Bailey Steel Co. v. Bank of Pittsburgh*, 277 Pa. 81, 120 Atl. 698

historic concept that a bill of exchange was originally used for payment. Today, however, it is used as a "time instrument" to give the debtor an extension of time on his obligation, and to place the creditor in a more liquid position by availing him of the possibility of discounting the bill.⁷² Thus, at common law, the concept of "collateral security" was grounded on the functional use of a promissory note rather than its use as a source of funds for payment and, consequently, this concept fell into disuse when the function of a note was expanded. Under the Code, variation based upon the type of instrument, i.e., the functional use, is rejected by implication.⁷³ But, the holder discharges any party to the instrument if he unjustifiably impairs any collateral for the instrument given by the party, or on his behalf, or by any person against whom he has a right of recourse.⁷⁴

2. *Judicial Analysis of "Conditional Payment" Based on the Intent of the Parties*

The theory that the intent of the parties determines whether a negotiable instrument is payment fails to simplify the question of whether an action on the underlying obligation survives an action on a negotiable instrument.⁷⁵ Insofar as evidence is required to show this intent, the courts vary from a restrictive attitude (the necessity of an express agreement),⁷⁶ to a liberal one, which admits parol evidence to indicate the circumstances surrounding the transaction.⁷⁷ The liberal view raises the question of whether or not the parol evidence rule operates against both the plaintiff and defendant equally.⁷⁸ Even though "it is elementary that most defenses necessarily rest in parol,"⁷⁹ it is not so apparent that testimony which "tends to vary the terms of the instrument," such as evidence that

(1923), *aff'd*, 283 Pa. 203, 129 Atl. 53 (1925) (check presumed to be collateral security); *City of Philadelphia v. Neill*, *supra* note 63 (notes—even third party—are collateral security, or at most conditional payment); *United States v. Hegeman*, *supra* note 63 (acceptance of new bill from acceptor after maturity for future payment is collateral security).

⁷² Kessler, Levi & Ferguson, *supra* note 64.

⁷³ The Uniform Commercial Code stresses form of negotiable instruments rather than function. U.C.C. §§ 3-104, -805.

⁷⁴ U.C.C. § 3-606(1)(b).

⁷⁵ *Economy Fuse & Mfg. Co. v. Standard Elec. Mfg. Co.*, 359 Ill. 504, 194 N.E. 922 (1935) (check indorsed as "accord and satisfaction").

⁷⁶ *Bell v. McDonald*, 308 Ill. 329, 139 N.E. 613 (1923) (holder of promissory note allegedly procured by fraud).

⁷⁷ *Feinberg v. Levine*, 237 Mass. 185, 129 N.E. 393 (1921) (no evidence that creditor treated as payment); *Gehring v. Real Estate-Land Title & Trust Co.*, 321 Pa. 401, 184 Atl. 100 (1936) (circumstances did not indicate contrary intent).

⁷⁸ *Britton*, *supra* note 37, § 51, at 200-03.

⁷⁹ *Id.* at 201.

the parties intended conditional as opposed to absolute payment,⁸⁰ does not violate the rule. The very least that can be said is that a determination of the "intent of the parties" raises complicated evidentiary problems. To avoid these problems, courts have developed various presumptions which arise upon the taking of a negotiable instrument.

"Intent" is retained in the Code as it relates to discharge on the instrument; for example, the holder may intentionally cancel or destroy the instrument or may renounce his rights.⁸¹ It should be noted, however, that these are affirmative acts by the holder requiring external proof, and are codified into the statute.⁸² Manifest intent, which is adopted by statute, cannot be properly equated to subjective undisclosed intent, nor is subjective intent a satisfactory basis for determining whether a negotiable instrument conditionally satisfies the underlying obligation.

3. *Judicial Use of "Presumptions" to Determine Whether a Negotiable Instrument is Conditional Payment*

Under the Law Merchant, the taking of a negotiable instrument was "prima facie" evidence of satisfaction of the underlying obligation. A presumption was raised that the creditor had been paid.⁸³ Even where a renewal note was taken, it was held that the holder-creditor must account for the renewal note before he could recover on the original note. "Prima facie" evidence of satisfaction of the underlying obligation was rebuttable.⁸⁴

Under the Negotiable Instruments Law, the doctrine of conditional payment developed regarding checks, notes and drafts, and the courts developed presumptions to favor certain instruments and the parties thereto.

In the instance of promissory notes, some cases held the presumption to be that claims arising out of the underlying contract were extinguished by a note—a presumption which could be strengthened by the parties' course of conduct.⁸⁵ Another line of cases has held that a non-negotiable note did not raise the presumption of payment,⁸⁶

⁸⁰ See 9 Wigmore, Evidence § 2425 (3d ed. 1940) for definition of parol evidence rule.

⁸¹ U.C.C. § 3-605.

⁸² U.C.C. § 3-605(1)(b).

⁸³ *State v. Adams*, 187 Ind. 165, 118 N.E. 680 (1918) (payment by renewal note); *State v. Hulihan*, 92 Ind. App. 78, 157 N.E. 282 (1931) (surety defended payment by note).

⁸⁴ *State v. Adams*, supra note 83.

⁸⁵ E.g., *Duvall v. Ransom & Randolph Co.*, 90 Ind. App. 605, 169 N.E. 537 (1930) (promissory notes given in payment of chattels).

⁸⁶ *Riedman v. Macht*, 98 Ind. App. 124, 183 N.E. 807 (1932) (convertor of check gave a promissory note in payment). Contra, *id.* at 128, 183 N.E. at 809 (where negotiable notes).

or that a debt was not paid by giving a note for a pre-existing indebtedness.⁸⁷ The conflicting use of presumptions is illustrated by the fact that in Indiana an appellate court held a promissory note gave rise to the presumption of payment⁸⁸ while in New York, at approximately the same time, it was held that a strong presumption arises that the parties did not intend the debt to be extinguished by promissory notes.⁸⁹

In cases involving payment by check, the weight of authority is that a check does not raise the presumption of payment; it is merely conditional payment.⁹⁰ Yet, under the N.I.L., decisions are by no means uniform. Other factors are considered significant, such as whether certification was requested by the holder-creditor,⁹¹ whether the creditor was guilty of laches,⁹² whether the debtor was primarily or secondarily liable on the instrument⁹³ and whether the instrument was that of a third party.⁹⁴

The lack of uniformity in presumptions raised is indicated by the New Jersey annotation to section 3-802 of the Code: "these rules impress one as inconsistent and haphazard."⁹⁵ This comment refers specifically to the presumption of payment arising where a third party instrument is given concurrently with the creation of a debt. The annotator describes this presumption as being continued under section 3-802(1) of the Code, and states, "that no good reason [exists] to presume the parties presumptively have agreed to take the instrument in discharge of the obligation . . . unless the underlying obligor is not liable on the third party instrument," if he, for instance, transfers the bill or note without indorsing it. Although presumptions are useful in ascertaining court policy, they do not effectively serve to indicate the basis for this policy.

⁸⁷ *Newhall v. Arnett*, 279 Pa. 317, 123 Atl. 819 (1924) (suit against accommodation maker of note).

⁸⁸ *Duvall v. Ransom & Randolph Co.*, *supra* note 85.

⁸⁹ *Sedwitz v. Arnold*, 164 Misc. 892, 299 N.Y.S. 848 (City Ct. 1937) (acceptance of promissory note in payment of antecedent debt).

⁹⁰ *Tuckel v. Jurovaty*, 141 Conn. 649, 109 A.2d 262 (1954) (third party check); *Baughman v. Lowe*, 41 Ind. App. 1, 83 N.E. 255 (1908) (client accepted attorney's check); *Nason v. Fowler*, 70 N.H. 291, 47 Atl. 263 (1900) (tax collector accepted check).

⁹¹ See generally 14 Wyo. L.J. 39 (1959).

⁹² *Danks v. Kropp Steel Co.*, 21 Ill. App. 2d 252, 157 N.E.2d 694 (1959) (creditor must return check offered as accord and satisfaction); *Cochrane v. Zahos*, 286 Mass. 173, 189 N.E. 831 (1934) (laches will effect discharge on postdated check).

⁹³ *Tuckel v. Jurovaty*, *supra* note 90 (fact that debtor was indorser does not alter liability); *Carroll v. Sweet*, 128 N.Y. 19, 27 N.E. 763 (1891) (if debtor secondarily liable, failure of conditions precedent discharge him).

⁹⁴ *Contra*, *ibid* (fact that instrument is that of third party does not alter result). See *Cox v. Hayes*, 18 Ind. App. 220, 47 N.E. 844 (1897); *Fleig v. Sleet*, 43 Ohio St. 53, 1 N.E. 24 (1885); *Wendkos v. Scranton Life Ins. Co.*, 340 Pa. 550, 17 A.2d 895 (1941).

⁹⁵ N.J. Rev. Stat. § 12A: 3-802 (1962).

4. *Instruments Taken for Pre-existing as Opposed to Contemporaneous Debts*

Another factor in determining whether a payment was "conditional" at common law was whether the instrument was given in satisfaction of a pre-existing or contemporaneous debt. "It is a general principle of law that one simply, [sic] executory contract does not extinguish another for which it is substituted, and negotiable securities form no exception."⁹⁶ An expression of this statement can be found as early as 1694 in *Clerke v. Mundall*,⁹⁷ where Lord Holt said, "a bill shall never go in discharge of a precedent debt, except it be part of the contract that it shall be so."⁹⁸ An English statute,⁹⁹ passed ten years later, provided that where a bill was taken for a former debt it was complete payment of the debt. *Clerke* seems to turn on a question of fact, that the creditor took the bill of exchange from his debtor who was an indorser on the bill, and the creditor had a reasonable time to accept or reject it. The status of the parties, rather than the fact that the bill was consideration for a pre-existing debt, is significant. The now-almost-forgotten statute took as its basis the functional aspect of the instrument.

There is case law, however, supporting the proposition that where a creditor takes a note for a pre-existing debt it is absolute, not conditional, payment.¹⁰⁰ Courts have fallen into pitfalls by using this distinction as a basis for determining liability on the underlying obligation. In *Keller v. North Am. Life Ins. Co.*,¹⁰¹ the plaintiff-beneficiary of a life insurance policy which was canceled brought an action to recover the cash value prior to cancellation. The defendant insurer contended that since the payment had been made partly in cash and partly by a note which was unpaid, the balance of the unpaid note should be deducted from the cash value. The trial court's holding for the defendant was reversed because the note was held to have been given in consideration of a pre-existing debt and, therefore, was

⁹⁶ Daniel, *supra* note 66, § 1448, at 1491.

⁹⁷ Although the case is widely cited for the proposition that a note does not discharge a pre-existing debt, it turned on the issue that the creditor had a reasonable time to accept or reject the note as payment which was a question of fact. *Clerke v. Mundall*, 12 Mod. 203, 88 Eng. Rep. 1263 (K.B. 1694).

⁹⁸ *Ibid.*

⁹⁹ An Act for Giving Like Remedy on Promissory Notes as is now used upon Bills of Exchange and for the Better Payment of Inland Bills of Exchange, 3 & 4 Anne, c.9, § 7 (1704).

¹⁰⁰ *Nixon v. Beard*, *supra* note 63 (surety executed note). *Contra*, *Dow v. Cowan*, 23 F.2d 646 (8th Cir. 1927) (check in payment of promissory note); *Mellencamp v. Reeves Auto Co.*, 100 Ind. App. 26, 190 N.E. 618 (1934) (conditional seller accepted renewal note on obligation); *Sedwitz v. Arnold*, *supra* note 89 (creditor accepted promissory note); *Jagger Iron Co. v. Walker*, 76 N.Y. 521 (1879) (renewal notes accepted); *Merrick v. Boury*, 4 Ohio St. 60 (1854) (note altered by creditor).

¹⁰¹ *Keller v. North Am. Life Ins. Co.*, 301 Ill. 198, 133 N.E. 726 (1921).

not the equivalent of a payment, thus resulting in a complete forfeiture! Suretyship cases are rife with such logic. In *Droege v. Hoagland State Bank*,¹⁰² the maker's father had signed as surety on an earlier note, and his signature was forged on a subsequent renewal note. The bank-payee of notes given in payment of the earlier note sued the father, who defended on grounds of release. The court held that a good faith acceptance of a renewal note on which the signature of the surety has been forged from the principal does not operate as payment of the original note so as to extinguish the payee's right of action thereon despite the negligence of the payee.¹⁰³ It should be clear from this discussion that a hard and fast rule dealing with pre-existing indebtedness is at best another subdivision of judicial presumptions which will not lend consistency to the law.

5. *Negotiable Instruments as an "Accord and Satisfaction" of Underlying Obligations*

One can also find language in some cases indicating that the factor of whether a negotiable instrument was given for a liquidated or unliquidated debt (accord and satisfaction) is significant in determining liability on the underlying obligation. For example, in *Neher v. Kerr*,¹⁰⁴ a creditor sued a debtor on account. The debtor defended that the debt was unliquidated and that the creditor had accepted a negotiable instrument in a lesser amount. The court held that where a bona fide dispute exists as to the amount due, and the creditor accepts a negotiable instrument in full payment, the account is discharged; the payment is not conditional. In the landmark case of *Fleig v. Sleet*,¹⁰⁵ the plaintiff-vendor brought an action on account and the defendant, an indorser of a third party check which was subsequently dishonored, defended that there was an accord and satisfaction. The court held that, although there was an accord as to the amount of the unliquidated account, the delivery of a worthless check was *not* satisfaction. The court added in obiter dictum that had delay of presentment caused prejudice, a different question could have arisen. Other cases indicate that where a negotiable instrument is given as an accord and satisfaction, the creditor must accept it as such,¹⁰⁶

¹⁰² *Droege v. Hoagland State Bank*, supra note 63.

¹⁰³ Compare *Emerine v. O'Brien*, supra note 63 (forged note does not operate as satisfaction of antecedent debt) with *Droege v. Hoagland State Bank*, supra note 63. Cf. *State v. Adams*, supra note 83 (surety not released by renewal notes); *Knight v. Kerfoot*, 184 Ind. 31, 110 N.E. 206 (1915) (surety released by renewal notes which she did not sign); *Kirchstein v. Dreazen*, 128 Misc. 686, 219 N.Y.S. 697 (Munic. Ct. 1927) (surety released by varying terms).

¹⁰⁴ *Neher v. Kerr*, 70 Ind. App. 363, 123 N.E. 467 (1919).

¹⁰⁵ *Fleig v. Sleet*, supra note 94.

¹⁰⁶ *Federal Cas. Co. v. Chatman*, 69 Ind. App. 67, 121 N.E. 296 (1918) (insurer's

or the instrument must explicitly state the compromise¹⁰⁷ or there must at least be a mutual agreement.¹⁰⁸ One recent case held that a duty arises on the part of the creditor to accept or specifically reject the instrument.¹⁰⁹

Even though payment by negotiable instrument is an affirmative defense with the burden of proof on the party asserting it,¹¹⁰ the pleading may raise the issue of discharge on the underlying obligation arising from an accord and satisfaction. Prior to Supplement No. 1 to the 1952 Official Text, section 3-802(3) provided:

Where a check or similar payment instrument provides that it is in full satisfaction of an obligation the payee discharges the underlying obligation by obtaining payment of the instrument unless he establishes that the original obligor has taken unconscionable advantage in the circumstances.

This subsection was in accord with the weight of authority when a debt was unliquidated;¹¹¹ however, when the debt was liquidated, it effected a substantial change.¹¹² Even though the effect of the Code rule was modified by the statement that the underlying debt was not discharged where the payee "establishes that the original obligor has taken unconscionable advantage in the circumstances," no authority directly bearing on unconscionability was noted.¹¹³ As a result of the deletion of this section, it is doubtful that an underlying obligor would be released from a liquidated debt by discharge on an instrument marked "in full payment," but for a sum less than the full amount of the stated account. For example, *A* owes store *B* twenty dollars and indorses a third party check for ten dollars as "payment in full." When the check is dishonored, *A* is discharged for late presentment. Query, is *A* discharged on his twenty dollar account?¹¹⁴ The answer is not clear, but, at any rate, the current provisions of the Code do not adopt the rule contained in section 3-802(3).

check issued in compromise of claim). *Accord*, *Economy Fuse & Mfg. Co. v. Standard Elec. Mfg. Co.*, *supra* note 75 (check indorsed as "payment in full").

¹⁰⁷ *Talbott v. English*, 156 Ind. 299, 59 N.E. 857 (1901) (check indorsed "rent").

¹⁰⁸ *Girard Fire & Marine Ins. Co. v. Canan*, 195 Pa. 589, 46 Atl. 115 (1900) (evidence adduced that creditor did not notice check marked "full payment").

¹⁰⁹ *Danks v. Kropp Steel Co.*, *supra* note 92; *Federal Cas. Co. v. Chatman*, *supra* note 106 (check must be accepted). *Contra*, *Economy Fuse & Mfg. Co. v. Standard Elec. Mfg. Co.*, *supra* note 75 (no obligation to return). See *East Coast Dry Goods Co. v. Somerset Sportswear, Inc.*, 151 So. 2d 68 (Fla. App. 1963) (evidence of restrictive indorsement not sufficient to substantiate accord and satisfaction).

¹¹⁰ *Ibid.* See *Murray*, *Negotiable Instruments*, 18 U. Miami L. Rev. 416, 425 (1963).

¹¹¹ 2 N.Y.L. Revision Comm., *Study of the Uniform Commercial Code*, Article 3—Commercial Paper 446 (1955).

¹¹² *Ibid.*

¹¹³ *Ibid.*

¹¹⁴ See *Okla. Stat. Ann.* 12A § 3-802 (1963). See also *U.C.C.* § 2-209, Comment 2 (test of good faith).

UNDOING OF AN OBLIGATION

Insofar as "conditional payment" affects the obligor's liability on the underlying obligation, the following observations may be made:

(1) The initial concept of collateral security arose when a promissory note was used primarily as a means of payment and, therefore, discharge of an indorser from his liability for the underlying obligation due to the laches of the holder might not occur when the note was taken as "collateral security."¹¹⁵ Consideration of the obligor's liability on the underlying obligation should be balanced by the realization of the expanded use of promissory notes, and by the consideration that the courts have never clearly defined this concept.

(2) Intent of the parties, if used as a subjective standard, flaunts the purpose of the Code as found in section 1-102 "to simplify, clarify and modernize the law governing commercial transactions . . . [and] to make uniform the law among the various jurisdictions." Additionally, objective manifestations of "intent" have been codified in the Code.¹¹⁶

(3) The use of presumptions to explain conditional payment has been shown to be inconsistent and haphazard, and adds little to uniformity.

(4) Whether a negotiable instrument is held as consideration for a pre-existing or contemporaneous debt does little to indicate the expectations of the parties, and is but another form of presumption.

(5) Finally, the use of accord and satisfaction as a device to determine the liability of the underlying obligor appears to have been rejected by the Commissioners and, if in conflict, would be rejected by the courts.

Conditional payment fails to provide a satisfactory basis for discharge on the underlying obligation, and fails to provide a reliable method for resolving the conflicting expectations of the parties. For example, it is not clear why a payee-indorser who takes from the insolvent drawer, should be released for failure of timely presentment when it is assumed that timely presentment would not enable him to collect from the drawer. Yet, the decisional law that has developed under the doctrine of conditional payment would prescribe this result whether or not the indorser was injured by the delay in presentment.¹¹⁷ "Conditional payment" only seems to be a method of categorizing those conditions under which the effect of taking a negotiable instrument is to merge the underlying obligation with the liabilities arising from the instrument itself. For this reason, the concept of "merger" merits further consideration.

¹¹⁵ See text accompanying note 70 *supra*.

¹¹⁶ U.C.C. § 3-605(1).

¹¹⁷ Accord, *supra* note 47 (cases concerning drawers who are discharged without injury or injury presumed; the same conditions are true for indorsers).

B. *The Doctrine of Merger*

"Merger" exists when the relationship of "liability on the instrument" and "liability for the underlying obligation" are identical. Where a negotiable instrument is taken for an underlying obligation and the merger is permanent, the negotiable instrument is an absolute payment of the underlying obligation. This transaction is commonly called absolute payment. Where there is a "partial merger," a "pro tanto" discharge of the underlying obligation, the original debt still remains, but the remedy is merged "on the instrument till the maturity of the instrument in the hands of the creditors."¹¹⁸ Where a partial merger (hereinafter referred to as a "pro tanto discharge") occurs, action on the underlying obligation is proscribed and the holder must look to his remedies on the instrument against parties who may be primarily, intermediately, or secondarily liable. The holder-creditor may always look to the party who is primarily liable on the instrument without the necessity of observing conditions precedent. The holder-creditor, however, must observe the conditions precedent to fix the liability of parties who are intermediately or secondarily liable. In the case of parties who are intermediately liable, failure of the holder to observe the conditions will discharge the intermediate party only to the extent that the failure has injured that party.¹¹⁹ A party who is secondarily liable may be completely discharged on the instrument by such failure. When the underlying obligation is merged, permanently or partially, in the instrument and the party who is secondarily liable is discharged from his contractual obligations on the instrument, he is also discharged, permanently or partially, on the underlying obligation. If, arguendo, a party who is secondarily liable should not be discharged from the underlying obligation, the fault must lie with the doctrine of merger, the status of the party (secondary liability), or his contractual obligations. "Merger" will be examined as it existed under the early theory of "absolute payment" (absolute merger), the later theory of "pro tanto discharge" (partial merger), and the effect thereon of laches.

1. *The Property Concept of a Negotiable Instrument: Quid Pro Quo*

The taking of a negotiable instrument in satisfaction of an underlying obligation involved the idea of *quid pro quo*, in that the merchant understood the value of what he was receiving to be the satisfactory equivalent of the debt, is a fundamental notion of "absolute payment." Certification of a check procured by the holder is held to be the equivalent of payment, and discharges the drawer and prior

¹¹⁸ Byles, Bills, Notes & Checks § 554 (3d ed. 1928).

¹¹⁹ U.C.C. § 3-502.

indorsers on the underlying obligation.¹²⁰ Originally, when a creditor accepted a third party instrument for a debt contracted contemporaneously with the acceptance, a presumption arose that the creditor took the instrument in absolute payment.¹²¹ The change in the functional concept of a bill of exchange has already been noted.¹²² This resulted in holdings that the fact that instruments were third party did not effect liability on the underlying obligation.¹²³

The Code adopts the position that where a holder procures certification of a check, the drawer and all prior indorsers are discharged.¹²⁴ Moreover, although the language of N.I.L. section 119 indicates that the instrument itself could be discharged, it left uncertainties as to the effect of a discharge upon subsequent holders in due course.¹²⁵ The Code speaks of discharge of the parties indicating a shift away from the common law notion of a negotiable instrument as property.¹²⁶

2. *Pro Tanto Discharge*

Justice Travis, dissenting from a decision of the Indiana Supreme Court holding that a note was merely conditional payment, affirmed the rationale of an earlier opinion that "it is necessary to commercial transactions that the rules of liability of parties to negotiable paper should be fixed and certain," because it is better that rules be arbitrary than that they lack precision.¹²⁷ This policy is reflected in early cases which hold payment is an absolute release. In an early Ohio case, the court held that where one note is given in renewal of another, the former is regarded as merged in and discharged by the other.¹²⁸ The

¹²⁰ E.g., *Karvalsky v. Becker*, 217 Ind. 524, 29 N.E.2d 560 (1940); *Nardine v. Kraft Cheese Co.*, 114 Ind. App. 399, 52 N.E.2d 634 (1944); *Kinder v. Fishers Nat'l Bank*, 93 Ind. App. 213, 177 N.E. 904 (1931). Cf. *Born v. Lafayette Auto Co.*, 196 Ind. 399, 145 N.E. 833 (1924) (where drawer procures certification).

¹²¹ *Dibble v. Richardson*, 171 N.Y. 131, 63 N.E. 829 (1902). But see *Orange Screen Co. v. Holmes*, 103 N.J.L. 560, 138 Atl. 105 (Sup. Ct. 1927) (third party instrument only pro tanto discharge). Accord, *Bradway v. Groenendyke*, 153 Ind. 508, 55 N.E. 434 (1899) (no express agreement as to effect of note). See also *Newell v. Newell*, 213 Ind. 261, 12 N.E.2d 344 (1938) (third party instrument must be shown to be payment by preponderance).

¹²² A bill of exchange was originally used as a form of payment, but now is considered a time instrument. For a discussion of the purposes of notes, see *Riedman v. Macht*, *supra* note 86.

¹²³ *Wendkos v. Scranton Life Ins. Co.*, *supra* note 94 (third party check given in payment of insurance premium); *City of Philadelphia v. Neill*, 211 Pa. 353, 60 Atl. 1033 (1905) (dictum) (third party note is not absolute payment).

¹²⁴ U.C.C. § 3-411(1).

¹²⁵ U.C.C. § 3-601, Comment 2.

¹²⁶ *Ibid.*

¹²⁷ *Born v. Lafayette Auto Co.*, *Supra* Note 120, at 411-21, 145 N.E. at 837-40 (dissent).

¹²⁸ *Bank of Cadiz v. Slemmons*, 34 Ohio St. 142 (1877) (dictum) (new notes delivered on settled amount).

landmark case of *Shipman v. Cook*¹²⁹ stood for the proposition that delivery of a bill or note is not payment of a precedent debt, but merely suspends the remedy. In *Visnov v. Levy*,¹³⁰ frequently cited in annotations to section 3-802(1)(b), the court announced the law under the Uniform Commercial Code to be that payment by check effects a pro tanto suspension of the debt.¹³¹ Temporary suspension of the remedy on the underlying obligation avoids multiplicity of suits by first requiring an action for liability arising from the instrument itself.¹³² Since the contractual liabilities of the parties are fixed by statute, "uniform law among the various jurisdictions"¹³³ can be accomplished. Thus, pro tanto discharge has been adopted by the Code to accomplish uniformity and avoid multiplicity of actions. But since, under the Code, the acts of a holder can effect discharge, pro tanto discharge can become absolute where the party to be charged has been injured by the holder's laches.

3. Laches of the Holder

In *Orange Screen Co. v. Holmes*,¹³⁴ the court stated that the rule of pro tanto discharge applied, but went on to say that where a third party note was taken, "if the holder be guilty of laches, it operates as a complete satisfaction."¹³⁵ The "no harm—no discharge" rule developed from this early concept: if a bill is received as conditional payment, failure to observe conditions precedent neither compels the obligee to take the instrument as absolute payment nor deprives him of an action on the original debt where the failure does not cause injury to the drawer.¹³⁶ If, however, a check is not presented within a reasonable time, and the drawer suffers a loss, he is discharged on the instrument¹³⁷ and from the underlying obligation to the extent of the loss caused by the delay.¹³⁸

¹²⁹ *Shipman v. Cook*, 16 N.J. Eq. 251 (Ch. 1863) (third party note indorsed in part payment of mortgage debt).

¹³⁰ *Visnov v. Levy*, 2 Pa. D. & C.2d 686 (Phila. 1955).

¹³¹ *Id.* at 688. See *McCrary v. Carrington*, 35 Ala. 698 (1860); *Phoenix Inc. Co. v. Allen*, 11 Mich. 501 (1863); *Hoar v. Union Mut. Life Ins. Co.*, 118 App. Div. 416, 103 N.Y.S. 1059 (1907) in regard to pro tanto discharge.

¹³² *Sutton v. Baldwin*, 146 Ind. 361, 45 N.E. 518 (1896) (creditor accepted check).

¹³³ U.C.C. § 1-102.

¹³⁴ *Orange Screen Co. v. Holmes*, *supra* note 121.

¹³⁵ *Id.* at 561, 138 Atl. at 105. See also *Shipman v. Cook*, *supra* note 129; *Hall v. Green*, 14 Ohio 499 (1846) (laches of holder released indorser of note). For cases holding that laches of holder released drawer, see *Commercial Inv. Trust v. Lundgren-Wittensten Co.*, 173 Minn. 83, 216 N.W. 531 (1927); *Smith v. Miller*, 52 N.Y. 545 (1873). Cf. *Minehart v. Handlin*, 37 Ark. 276 (1881) (drawer of draft discharged by failure of condition precedent without injury).

¹³⁶ *Carroll v. Sweet*, *supra* note 93.

¹³⁷ *Gordon v. Levine*, 194 Mass. 418, 80 N.E. 505 (1907).

¹³⁸ *Cochrane v. Zahos*, *supra* note 92.

UNDOING OF AN OBLIGATION

In summary, although the doctrine of absolute merger has not been adopted by the Code, other than where a holder procures certification of a check, the doctrine of pro tanto discharge (partial merger) of the underlying obligation is expressly adopted.¹³⁹ Unlike conditional payment which looks to such factors as collateral security, intent of parties, presumptions, pre-existing indebtedness and accord and satisfaction, all of which have resulted in conflicting precedent, pro tanto discharge looks to the liability of the parties to a negotiable instrument. The Code's concept of commercial paper and the requisites of negotiability concern form alone and presuppose a unitary concept of commercial paper. Pro tanto discharge conforms to this unitary concept by looking first to the liability of the parties on the instrument, and then to their liability on the underlying obligation. It is for this reason that section 3-802 of the Code adopts the doctrine of pro tanto discharge. Consequently, the doctrine is appropriate in analysing the relationship of liability on the instrument with liability for the underlying obligation. Such analysis, however, fails to answer the question why the Code adopts the doctrine of pro tanto discharge in the case of those parties intermediately liable, drawers of drafts and checks, and apparently rejects it for parties who are secondarily liable, indorsers. To answer this question, it is necessary to look to the statute itself.

III. THE PRACTICAL OPERATION OF SECTION 3-802(1)(b) OF THE UNIFORM COMMERCIAL CODE

A. *Two Hypothetical Problems*

Consider how the following hypothetical check payment situations would be resolved under the Code.

- (1) *A*, a good customer of *B*, presented a personal check drawn by *D*, whom *B* did not know, and who was totally insolvent when the check was drawn. The check was drawn on a local bank made payable to *A*, and specially indorsed by *A* to *B* in payment for goods. *B*, without excuse, misplaced the check for three weeks. When *B* presented the check for payment,¹⁴⁰ it was dishonored by the drawee bank. *A* refused to make the check good. Or,
- (2) *B* took the check given to him by *A*, the first indorser, and specially indorsed it the same day to his supplier, *C*, in payment of an invoice. *C*, without excuse, misplaced the check for three weeks. On presentment for

¹³⁹ U.C.C. § 3-802(1).

¹⁴⁰ U.C.C. § 3-501(1)(b).

payment, the drawee bank dishonored the check, whereupon *B* refused to make the check good.¹⁴¹

From what has been stated thus far, *A* in the first hypothetical, and *A* and *B* in the second would be released as indorsers on the check because of the unexcused failure to present the check for payment within a reasonable period of time.¹⁴² Furthermore, these parties would also be discharged on their underlying obligation because section 3-802(1)(b) provides ". . . discharge of the underlying obligor on the instrument also discharges him on the obligation." (Emphasis added.)

The official comment to this section states that a check or other negotiable instrument is "conditional payment," i.e. ". . . taking the instrument is surrender of the right to sue on the obligation until the instrument is due; but if the instrument is not paid on due presentment, the right to sue on the obligation is 'revived.'"¹⁴³ This definition of conditional payment more closely follows the definition of pro tanto discharge, and since discharge of the underlying obligor on the instrument also discharges him on the obligation, the statute has the effect of absolute payment.¹⁴⁴

The comment does little to answer the issue posed in the hypotheticals as to why the indorser of a check has a preferred position. The Code makes the rule (discharge of the indorser as opposed to discharge of the drawer) turn on the meaningless distinction between a drawer and indorser, and not on primary and secondary liability.¹⁴⁵ The confusion caused by this distinction is indicated by the comment of the New York Law Revision Commission¹⁴⁶ that "it is not clear . . . the obligor on an underlying obligation would be discharged on that obligation by a discharge of his liability on the instrument resulting from a failure of timely presentment or notice of dishonor." Research in the other state comments to this section has not proved fruitful in

¹⁴¹ For the purpose of this article it is assumed that the delay in presentment for payment does not result in waiver or excuse (neither *A* nor *B* knew that the drawer was insolvent); and, therefore, the provisions of U.C.C. § 3-417(2) are not applicable.

¹⁴² "Where without excuse any necessary presentment or notice of dishonor is delayed beyond the time when it is due (a) any indorser is discharged. . . ." U.C.C. § 3-502(1)(a). Presentment for payment must be within a reasonable time after the indorser's indorsement to hold him liable, which is presumed to be seven days after his indorsement. U.C.C. §§ 3-503(1)(e), (2)(b).

¹⁴³ U.C.C. § 3-802(1)(b), Comment 3.

¹⁴⁴ "Absolute payment" (merger) involves those situations in which the taking of a negotiable instrument "merged" the underlying obligor's debt into the instrument, thus making the instrument "absolute payment" of the debt.

¹⁴⁵ N.J. Rev. Stat. § 12A: 3-802 (1962), comments that this distinction "does not impress the writer as being an improvement."

¹⁴⁶ 2 N.Y.L. Rev. Comm. Study of the U.C.C. 445 (1955).

resolving the issue raised by the first hypothetical,¹⁴⁷ nor does an investigation of the official comments as to the reason for discharge of an indorser due to the failure of timely presentment. Section 3-503, Comment 3 of the Code indicates the policy behind discharge of the indorser to be that "the indorser who has normally received the check and passed it on, and does *not expect* to have to *pay it*, is entitled to know more promptly whether it is to be dishonored, in order that he may have recourse against the person with whom he has dealt." (Emphasis added.) This comment begs the question. Even admitting that the indorser does not expect to pay the check, it does not follow that he expects to escape liability for the underlying obligation. Furthermore, an assumption that the indorser is entitled to prompt presentment so that he can have recourse against a prior party only acknowledges that where he is deprived of that recourse and is injured thereby, he is entitled to discharge. This does not mean that the indorser should be released on the instrument and from the underlying obligation when he is not injured by the failure of timely presentment as in the case of the hypothetical problem. As a matter of fact, the indorser probably expects that if the instrument fails, he will have to pay for the underlying obligation!

B. *Alternatives and Evaluation*

Since the relationship of "liability on the instrument" and "liability for the underlying obligation" is not satisfactorily resolved by section 3-802(1)(b), an examination of alternatives is in order. The hypothetical problems serve as a useful method of analysing and evaluating such alternatives.

1. *The First Hypothetical Problem*

In the first fact pattern there seems to be no just reason why Indorser A should be discharged from the instrument and his underlying obligation. Even though A had the right to know promptly that the check was dishonored, the notice would not have enabled him to

¹⁴⁷ E.g., Cal. Commercial Code § 3802, Comment 4:

Subparagraph (1)(b) provides that upon maturity of the instrument an action may be maintained either on the debt or upon the instrument at the option of the holder. Assuming an irrevocable election is contemplated, and this is inferred in the comment following the section, it might be desirable to use more explicit language to indicate precisely when and how such an election is made;

Ind. Ann. Stat. § 19-3-802 (1964), Comment:

Negotiable instruments frequently are given and received for an underlying negotiable or non-negotiable obligation. Rules for determining when the underlying obligation is discharged or suspended are stated by this section. . . . The rules stated by this section are subject to contrary agreements which may be important to show either that a conditional discharge is unconditional or that a pro tanto discharge is intended to serve as a total discharge.

collect from Drawer *D* because *D* was assumed to be judgment proof. Moreover, as a practical matter, *A* would no more expect to have a worthless check "pay" for the goods purchased than he would a counterfeit bill! The notion of discharge from the underlying obligation of the indorser does not correlate with commercial understandings.

In commercial practice a check is used for the "payment" function, and parties to the instrument should be held to its commercial usage. The fact that by custom and usage an indorser seldom dates his indorsement is indicative that timely presentment is not the reason for the indorsement. The indorser uses the instrument to satisfy an underlying obligation, and understands that payment of the instrument will discharge the underlying obligation.

The equitable solution to the problem, therefore, is not to discharge *A* from the underlying obligation since it was he who took the check from *D* and not *B* (the seller-indorsee). One satisfactory method of accomplishing this, which has already been indicated, is based solely on an "effect test": to change the contractual liability of the indorser from that of secondary liability, by which he would be afforded complete discharge on the instrument, to intermediate liability where his discharge would only be to the extent of the injury caused by the delay in presentment for payment by the holder. Even a cursory examination of the pertinent Code sections¹⁴⁸ indicates the redrafting implications. Beyond this impediment, the ramifications of such a change in the law in those states which have not adopted the Code are enormous. This is by no means intended as a statement that such a change of the contractual liability of the indorsers is not desirable; however, such a change could not be substantiated by this article.

Under the first hypothetical, a drastic revision of contractual liability is unnecessary since the alternative remedy of an amendment to section 3-802(1)(b) could accomplish the result of not releasing *A* on his underlying obligation, even if he is released on the instrument. The condition for discharge on the underlying obligation could be stated to be "to the extent of injury due to the laches of the holder."¹⁴⁹

2. *The Second Hypothetical Problem*

A clear distinction should be drawn between the two problems

¹⁴⁸ Sections illustrating the problem's dimensions are U.C.C. §§ 3-414, -417, -501 to -503, -601.

¹⁴⁹ U.C.C. § 3-502, Comment 2 notes the difficulty caused by the language "to the extent of the loss caused by the delay." The comment refers to a bank insolvency situation which does not seem to be as commercially significant today as the discharge of an indorser from the instrument.

presented. In the first situation three parties are involved, *D* (the drawer of the check), *A* (the payee-indorser), and *B* (the holder), while in the second, the check has been negotiated an additional time so that *B* becomes a subsequent indorser, and *C* becomes the holder. The critical distinction is that of the contractual obligations between *C* and *A*, the payee-indorser, since they are not in privity with each other.

Under the additional facts in the second problem, the "expectation argument" breaks down. Even though *A* would not have been able to collect from *D* in the first example, had there been timely presentment, the same cannot be said of *B*'s rights against *A* in the second example. As a matter of fact, assuming a timely presentment by *C*, *A* would be liable to subsequent indorsers and holders.¹⁵⁰ Thus by *C* not presenting the check for three weeks, *B*'s procedural rights against *A* on the instrument have been adversely affected. Looking to commercial practice again, there is nothing to indicate the necessity of extending the liability of any indorser past the warranty extension now provided under section 3-417(2); because the concept of negotiability by indorsement might be impaired should the indorser be required to give up his rights against his transferor, and yet be liable against a subsequent transferee.

The strongest argument in favor of changing the contractual liability of an indorser is equitable in nature. In the first problem, if *A*, the indorser who purchased goods with the check, is not discharged from the underlying obligation, *B*, the seller, can sue *A* and recover payment for the goods purchased. However, in the second problem, *C*, the holder, should not be able to reach *B*, the intermediate indorser, on the instrument or for the underlying obligation, because *C*'s unexcused delay in presentment for payment has caused *B* to lose valuable rights against *A*, the payee-indorser, who was not assumed to be insolvent. *C* cannot proceed against *A* on the underlying obligation because they are not in privity; and if *A* is discharged on the instrument, *C* is left with the loss even though the delay in presentment for payment has not injured *A*! Therefore, if the desired effect is to have the parties liable for the underlying obligation where they are not injured by the laches of the holder, *A* should be liable to *C*, despite the discharge of *B* on the instrument, to the extent of *A*'s liability to *B*. This could be accomplished by a change in *A*'s contractual liability on the instrument or, barring such a drastic revision, by an amendment taking into account the equities presented by the facts of the second hypothetical.

¹⁵⁰ U.C.C. § 3-414(1).

C. *Amendment*

To accomplish the desirable result suggested above, the following amendment to section 3-802(1)(b) and the Comment thereto is suggested:

(b) in any other case the obligation is suspended pro tanto until the instrument is due or if it is payable on demand until its presentment. If the instrument is dishonored action may be maintained on either the instrument or the obligation; DISCHARGE OF THE UNDERLYING OBLIGOR ON THE INSTRUMENT ALSO DISCHARGES HIM ON THE OBLIGATION TO THE EXTENT OF HIS INJURY WHERE THE UNDERLYING OBLIGOR HAS BEEN INJURED BY AN ACT OF THE HOLDER, BUT THE UNDERLYING OBLIGOR IS NOT OTHERWISE DISCHARGED.

COMMENT

3. The taking of a check or other negotiable instrument is a surrender of the right to sue on the obligation until the instrument is due, but if the instrument is not paid on due presentment the right to sue on the obligation is "revived." Subsection (1)(b) states this result in terms of suspension of the obligation, which is intended to include suspension of the running of the statute of limitations. Upon dishonor of the instrument the holder is given his option to sue on either the instrument or the underlying obligation. Where the original obligor has been discharged on the instrument he will be discharged on the underlying obligation only to the extent he has been injured by an act of the holder, but not otherwise.

Further, where the instrument has been transferred by more than one indorsement and the intermediate indorser is discharged on the instrument, an equitable assignment of the discharged indorser's rights against any prior transferor shall accrue to the subsequent indorser. For example, *A* indorses to *B* who indorses to *C*, and *B* is discharged, *C* shall be assigned *B*'s right against *A* on the instrument.