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THE NEW PAYMENTS CODE AND THE ABOLITION OF HOLDER IN DUE COURSE STATUS AS TO CONSUMER CHECKS

MARION W. BENFIELD, JR.*

Since 1977 a committee working under the auspices of the Permanent Editorial Board of the Uniform Commercial Code has been considering possible changes in Articles 3 and 4 of the Code to provide a legal structure governing electronic fund transfers. While checks are still used in the vast majority of transactions to move funds from one bank to another, a large and increasing proportion of such transfers are now made through electronic funds transfer devices.¹ The committee, called the "3-4-8" Committee,² has produced a number of drafts of proposed modifications to Articles 3 and 4 and at the 1982 annual meeting of the National Conference of Commissioners on Uniform State Laws (NCCUSL) presented a tentative draft entitled "New Uniform Payments Code" (NUPC).

Even though the Act has received a first reading before NCCUSL,³

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Professor Benfield was a student of Dean (then Professor) Steinheimer at the University of Michigan in 1964-65.

¹ For a brief description of the various forms of electronic funds transfers, see White, *Payment Systems Today—and Tomorrow*, 163 THE BANKERS MAGAZINE 26 (1980). White reports that one-third of all social security recipients receive their payments by direct (electronic) deposit to their bank accounts.

² The members of the "3-4-8" Committee are: Robert Haydock, Jr., Chairman, Boston, Massachusetts; Boris Auerbach, Cincinnati, Ohio; James L. Brown, Milwaukee, Wisconsin; John H. Higgs, New York, New York; Paul E. Homrighausen, San Francisco, California; McChesney H. Jeffries, Atlanta, Georgia; Mark Leymaster, Boston, Massachusetts; Richard H. Norris, III, Milwaukee, Wisconsin; Norman Penney, Ithaca, New York [Deceased 1981]; Hamilton F. Potter, Jr., New York, New York; Carlyle C. Ring, Jr., Washington, District of Columbia; Blair C. Shick, Cambridge, Massachusetts.

Hal Scott, a professor at Harvard Law School, serves as Reporter to the Committee. Peter Murray, a practitioner from Portland, Maine is Assistant Reporter.

The Committee's name derives from the Articles of the Commercial Code with which the Committee has dealt. The Committee's amendments to Article 8, dealing with uncertificated securities, for which Martin Aronstein of the University of Pennsylvania was Reporter, were approved by the American Law Institute and the National Conference of Commissioners on Uniform State Laws in 1977.

³ The Uniform Commercial Code Permanent Editorial Board is a joint committee of NCCUSL and the American Law Institute (ALI) which jointly sponsor the Code. After Per-

it will take at least two years and probably longer to produce a final draft. The draft presented to NCCUSL in 1982 is the first draft distributed for public criticism. Many policy decisions evidenced in that draft are tentative: further discussion and receipt of public comment will ensue. The reader should, therefore, understand that the Committee may modify the proposed NUPC rules discussed herein before final promulgation of the Act. The author hopes that this article will contribute to a general dialogue regarding NUPC which will help the Committee and the sponsoring organizations make their final decisions as to NUPC's substance.

NUPC as presently drafted is a complete treatment of the issues which arise as to checks and other payment mechanisms rather than a series of proposed amendments to U.C.C. Articles 3 and 4. It is presently anticipated that NUPC will entirely replace Article 4 of the Commercial Code and replace Article 3 as to checks and other drafts payable through a bank. Article 3, however, would remain the law applicable to promissory notes and to drafts not payable to, or drawn on, banks.⁴ One of the guiding principles of the NUPC draft is that the same legal rules should govern various forms of funds transfers, including checks and the developing electronic funds transfers mechanisms as well as other payment systems such as credit and debit cards. Therefore, in major part the draft treats all forms of funds transfers similarly. The similar treatment of paper and nonpaper transactions has changed significantly the rules applicable to the traditional check system.

Among the more significant changes in present check law are the abolition of holders in due course of consumer checks, the abolition of the rule of *Price v. Neal*,⁵ and a proposal that consumers have a right to reverse payment of checks for a limited time after final payment.⁶ This

manent Editorial Board approval of a final draft of NUPC, ALI and NCCUSL must approve the draft. Since both organizations meet only once a year, it will take some time to obtain approval of the sponsoring organizations, even after the "3-4-8" Committee produces a final draft. The final draft remains subject to modification up until adoption by the sponsoring organizations.

This article is based on the Discussion Draft presented to NCCUSL in 1981 since that draft is generally available. However, the "3-4-8" Committee already has produced a new draft since the 1981 NCCUSL meeting which, however, is not generally available. Occasionally this article refers to language of the revised draft.

⁴ Since NUPC makes significant changes in present Article 3, adoption of NUPC will result in a significant difference between the rules applicable to checks and drafts payable through banks on the one hand, and promissory notes and nonbank drafts on the other. This article will not undertake to evaluate the desirability of that variation in treatment.

⁵ 3 Burr. 1354, 97 Eng. Rep. 871 (1762). Under *Price v. Neal*, a drawee who pays over a forged drawer's signature cannot recover the payment from a person who gave value for the instrument in good faith. The Uniform Commercial Code codifies the rule in § 3-418 in a slightly different form.

⁶ NUPC 425 allows consumer-drawers to require the drawee bank to recredit their account even though the bank has already paid the check if the demand for recrediting came within three days after the check was issued.

article focuses on the proposed abolition of holder in due course status as to consumer checks and asserts that NUPC should distinguish between defenses of consumer-drawers of checks and subsequent third-party claims and that while consumer defenses should be available against subsequent transferees, third-party claims generally should be cut off as against subsequent holders who take in good faith, for value, and without notice of claims or defenses.⁷

I. MODIFICATION OF HOLDER IN DUE COURSE RULES

As noted, NUPC denies holder in due course status⁸ to transferees of consumer checks.⁹ (Even as to business checks, transferees can have due course rights only if the checks contain the legend "subject to due course rights."¹⁰) A consumer check is one drawn by a natural person on a consumer account.¹¹ A consumer account is one opened by "natural persons who have represented to the account institution that the account is to be used primarily for personal, family or household purposes or who have failed to make any representations about the purposes for which the account will be used."¹²

Since rights of subsequent transferees depend on whether the check is a consumer check, the subsequent transferee should be able to determine from an examination of the check that it is a consumer check. The only feasible way to fairly give subsequent transferees notice that a check is a consumer check is to identify consumer accounts and then treat all checks drawn on that account as consumer checks. NUPC therefore provides that checks drawn on consumer accounts are consumer checks regardless of the purpose for which the individual check is given.¹³

⁷ In a typical third-party claim situation, Payee of check endorses the check in blank and gives it to Employee to deposit. Rather than making the deposit, Employee transfers the check to X. X gives value and takes the check in good faith and without notice of claims or defenses. The question is whether Payee can recover the check or its proceeds from X.

⁸ Under the Commercial Code, a holder in due course is a person in possession of a negotiable instrument payable to him or to bearer, or endorsed-in-blank, who has given value for the instrument and who took it in good faith and without notice that it is overdue or of claims or defenses in regard to it. U.C.C. § 3-302. A holder in due course takes the instrument free of most claims and defenses of prior parties. U.C.C. § 3-305. NUPC continues the holder in due course rules of the U.C.C. However, NUPC speaks of persons "with due course rights" rather than holders in due course. NUPC 104.

⁹ NUPC does not use the term "consumer check." Under NUPC 103, a check drawn by a consumer-drawer is not subject to due course rights.

¹⁰ The 1981 Discussion Draft provided that nonconsumer checks were negotiable unless language within the order clearly indicated that the checks were non-negotiable. In the most recent revised draft, NUPC provides that nonconsumer checks are not negotiable unless the legend "subject to due course rights" appears on the check. NUPC 103.

¹¹ NUPC 52(1).

¹² NUPC 50(13).

¹³ The appropriate notice can be given subsequent transferees by simply printing on the check the phrase "consumer check" or by banks uniformly agreeing to an electronic code

The act imposes no duty on either the customer opening the account or the bank that the representation as to use of the account be accurate or that the account be used in the way the customer represented that it would be used. Apparently, therefore, a person who wished to have a nonconsumer account which would in fact be used primarily for personal, family, or household purposes could get such an account by falsely telling the bank that the account is to be used for business purposes.

There are several possible reasons why a person might desire a non-consumer account. First, some banks have a different fee and interest payment structure for business and for nonbusiness accounts. Therefore, designating an account as a business account might produce lower service fees or higher interest rates on account balances. Second, a particular person might prefer to be free from some of the restrictions imposed by NUPC on checks drawn on consumer accounts. For example, NUPC presently gives the customer a right to reverse payments made by consumer check for a limited period.¹⁴ The rule prevents payees of such checks from receiving final payment for that period. Drawers of checks may desire, however, that some of their payees get instant payment by presenting the check over the counter.¹⁵ That result can be achieved only by having a business account.

It is hard to judge exactly how the practice of designating accounts as consumer or business accounts might develop.¹⁶ Banks might insist that persons opening accounts accurately represent their use or, on the other hand, might be entirely content to allow consumer customers to call their accounts business accounts. However, even though NUPC does not impose a duty on the bank to see that customers properly designate their accounts, a bank which encouraged consumers to open nonconsumer accounts would run a risk that, as between the bank and its

identification for consumer checks. Of course, even if neither is done, the check still cannot be subject to due course rights unless the legend "subject to due course rights" appears on the check. *See supra* note 10 and accompanying text. If, however, the check is a consumer check, it presumably does not become subject to due course rights even though the payee induces the consumer-drawer to mark the check "subject to due course rights."

¹⁴ NUPC 425.

¹⁵ For example, Parent may give a check to Child with the desire that Child be able to get immediate cash over the counter. If the check is reversible for three days, the bank will hesitate to pay cash over the counter before the end of the three-day period. The reversibility rules as to consumer checks are among the most controversial rules of the present NUPC draft and the Committee may well substantially modify the reversibility rules before the Committee approves a final draft.

¹⁶ Rights of the drawer in addition to the right to reverse depend upon whether the account is a consumer account. NUPC 500-504 impose special requirements on banks as to periodic statements to holders of consumer accounts and NUPC 507 imposes special requirements as to documentation of a charge to a consumer account through an electronic terminal.

customer, the account nevertheless would be treated by the courts as a consumer account.¹⁷

As already noted, even nonconsumer checks are not negotiable¹⁸ under NUPC unless they contain the language "subject to due course rights." Again, it is hard to guess how the practice might develop: negotiable business checks might remain the standard, as they are today, or the non-negotiable check might become standard. Banks, however, are likely to have substantial influence on the question and it is very unlikely that drawers will decide on a check-by-check basis whether a check is to be negotiable. Since banks would gain some advantage from having business checks be negotiable,¹⁹ banks probably will encourage business customers to use negotiable checks. Although the discussion following refers primarily to consumer checks, the issues raised apply similarly to non-negotiable business checks.

In recent years there has been much criticism of the holder in due course rules which operate to cut off consumer defenses in the case of promissory notes.²⁰ The following example will illustrate why. Consumer purchases a used automobile from Dealer and gives in payment a negotiable promissory note payable in installments (or gives an installment sales contract which provides that Consumer will pay any assignee the full amount of the debt whether or not Consumer has a defense against Dealer). Dealer transfers the note (or installment sales contract) to a holder in due course (or good faith purchaser for value). The

¹⁷ Any such attempt would almost certainly be viewed as an improper attempt by the bank to reduce its potential liability to the depositor. As a result banks likely will hesitate to allow a depositor to designate a clearly personal, family, or household purpose account as a business account since the depositor might later claim that the bank induced the misdesignation.

¹⁸ In this article, the terms "negotiable" or "non-negotiable" will be used to describe checks subject to due course rights and checks not subject to those rights, respectively, even though the terms also carry some additional meaning in relation to such things as reification of the right in the paper.

¹⁹ Banks which allow depositors to draw against uncollected checks could secure due course rights as to negotiable checks and recover from prior parties free of claims or defenses. While NUPC does not continue the special rule of U.C.C. § 4-209 (which grants holder in due course status to a bank which allows a customer to draw against uncollected funds), the bank which permits a customer to draw against uncollected funds would seem to have given value under the ordinary due course rules which NUPC 104 continues. If the bank acts in good faith and without notice it becomes a holder in due course.

Drawee banks which improperly pay a check over a stop order are subrogated to the position of the payee or any due course holder. It is to the advantage of such a bank that the check be negotiable. See NUPC 425(7) (continuing the subrogation rules of U.C.C. § 4-407).

²⁰ See, e.g., M. BENFIELD, *SOCIAL JUSTICE THROUGH LAW: NEW APPROACHES IN THE LAW OF CONTRACTS* 186-87 (1970); Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit*, 52 *TEX. L. REV.* 1 (1973); Rohner, *Holder in Due Course in Consumer Transactions: Requiem, Revival or Reformation?*, 60 *CORNELL L. REV.* 503 (1975); Rosenthal, *Negotiability—Who Needs it?*, 71 *COLUM. L. REV.* 375 (1971).

automobile is substantially defective. Under negotiability rules, Consumer must pay the transferee even though Consumer would have a defense against Dealer if Dealer himself had sued for the price. In the fact situation described, the transferee is almost always a bank or finance company which regularly buys Dealer's paper. As a regular buyer of the paper, the transferee is in a better position than Consumer to know Dealer's general reliability and ability to respond in damages for contract breaches. Further, the transferee can put pressure on Dealer to perform its contracts with consumers. Many state legislatures concluded that it is unfair to allow such a transferee to recover free of Consumer's defenses and adopted statutes providing that transferees of consumer installment notes or installment contracts cannot take free of consumer defenses.²¹ Similarly, some courts held that transferees who regularly purchase consumer negotiable notes from a particular dealer are not entitled to holder in due course status as to notes taken from that dealer.²²

The attack on the holder in due course doctrine as applied to consumer promissory notes culminated in the Federal Trade Commission's promulgation of a rule prohibiting sellers from taking negotiable promissory notes evidencing the price of goods or services sold to consumers.²³ The FTC's action ended the slow process of destroying negotiability on a

²¹ See, e.g., IOWA CODE § 537, 3307 (Supp. 1978-79); MASS. GEN. LAWS ANN. ch. 244, § 12C (1959); WIS. STAT. § 422, 406 (1974). The Uniform Consumer Credit Code promulgated in 1968 by the National Conference of Commissioners on Uniform State Laws prohibited the taking of negotiable instruments other than checks in consumer credit sales. Under one alternative offered to the states, the Code permitted assignees to take free of defenses if the assignee notified the consumer of the assignment and the consumer did not notify the assignees of any defenses within three months. U.C.C.C. §§ 2.403, 2.404 alternative A, § 2.404 alternative B. The commissioners revised the Consumer Creditor Code in 1974 to delete the alternative which allowed the assignee to take free of defenses not raised within three months. U.C.C.C. §§ 3.307, 3.404, 3.405 (1974).

²² Probably the best known of the cases is *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967).

²³ 16 C.F.R. § 433.2 (1978). The regulation makes it an unfair trade practice under § 5 of the Federal Trade Commission Act to take or receive a consumer credit contract unless it contains the following notice in at least 10 point type:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY BY THE DEBTOR HEREUNDER SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

Under the regulation a negotiable instrument other than a check given by a consumer for the price of goods or services is a consumer credit contract. See 16 C.F.R. § 433.1(e),(i) (1982). The FTC rule does not, however, apply to notes taken for loans, nor to notes taken in real estate transactions. See J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 1137-45 (2d ed. 1980).

state-by-state, or even case-by-case, basis and effectively ended the battle over negotiability of consumer notes.

The Federal Trade Commission rule does not prohibit the taking of negotiable checks in consumer transactions and no state yet has passed legislation prohibiting negotiable checks in consumer transactions. Similarly, the writer knows of no cases in which a court denied negotiability to checks merely because the checks were transferred to a person who regularly took checks from a dealer who sells to consumers.

There are at least two reasons why prohibition of negotiability as to consumer instruments has not been extended to checks. First, checks ordinarily are paid within a few days after issuance and before the consumer discovers any breach of contract by the seller as to the goods or services for which the check is given. Denying negotiability would help the consumer only in those few cases in which the consumer discovers the breach in time to put in a stop order on the check. If the consumer does discover the dealer's breach in time to stop payment, usually the consumer is able to stop payment free of third-party rights. Merchants rarely transfer a consumer check outside the banking system:²⁴ such checks are usually deposited by the merchant in the merchant's bank account for collection. Only the merchant's depository bank is likely to be able to claim holder in due course status and, whether or not the bank could do so, only infrequently will that bank actually claim holder in due course status. Therefore, negotiability of consumer checks makes little difference to the consumer, in contrast to the negotiability of promissory notes which required a consumer to pay the price of defective goods even though the consumer knew of a defense and could have asserted it against the seller. Second, as a matter of policy, checks, as payment instruments rather than credit instruments, arguably should be treated like cash. Just as a consumer cannot get money back from a person who in good faith receives the money from the merchant the consumer paid, the person who in good faith takes a check from the merchant perhaps should not be subject to consumer defenses.²⁵

The fact that negotiability of checks is not a source of significant loss to consumers and that checks arguably should be treated like cash does not necessarily mean that the negotiability rules as to checks should be preserved. Although those negotiability rules may be relatively unimportant, on balance they might be better abolished.

Since few persons other than banks will be able to claim holder in

²⁴ A few reported cases exist, however, which apparently involve nonbank holders in due course of checks drawn by persons who would be consumer-drawers under NUPC. *See, e.g., Merrimack Farmers Exch., Inc. v. Elliott*, 11 N.H. 126, 276 A.2d 258 (1971).

²⁵ On a similar issue, the National Commission on Electronic Funds Transfers recommended that consumer electronic funds transfers be final when made, like a cash transfer, and not subject to reversibility. NATIONAL COMMISSION ON ELECTRONIC FUNDS TRANSFERS, EFT IN THE UNITED STATES, POLICY RECOMMENDATIONS AND THE PUBLIC INTEREST 51 (1977).

due course status on consumer checks, perhaps the determination of whether consumer checks should be negotiable turns on whether any justification exists for permitting banks to take checks free of consumer defenses by claiming holder in due course status.

Presently, under Articles 3 and 4 of the Commercial Code, a bank which permits its depositor to draw against a credit balance in the depositor's account created by deposited but uncollected checks may be a holder in due course of those checks.²⁶ Assume, for example, that Consumer pays \$5,000 by check for a used car. Consumer discovers shortly after the purchase that the automobile is substantially defective and stops payment on the check. In the meantime, Seller had deposited the check in his bank and Seller's bank has paid a check drawn on Seller's account which reduces Seller's amount to zero. When Consumer's bank returns the check unpaid, the simplest thing for Seller's bank to do is to charge back the amount of the check to Seller's account.²⁷ Alternatively, the bank can claim holder in due course status and recover the amount of the check from Consumer free of Consumer's defenses against Seller.

It seems unlikely that a bank which permits a depositor to draw against uncollected checks does so on the strength of the credit worthiness of the drawers of the checks or in reliance on the bank's ability to claim holder in due course status on the checks. More likely the bank relies on the fact that its depositor is a good customer who makes regular deposits, and if one check doesn't clear, another one will and make up any shortfalls. The bank also relies on the fact that in general the vast majority of checks are in fact paid. Banks typically assert their due course status only when they have misjudged their depositor and

²⁶ U.C.C. § 4-208(1), (2). Section 4-208(2) applies a first-in, first-out rule to determine whether a check payment or cash withdrawal from an account has been made against an uncollected check. For example, assume that Customer on January 2 opens an account with a cash deposit of \$10,000. On January 5 Customer deposits a check for \$10,000 and on January 7 deposits \$10,000 in cash. The account now contains \$30,000. On January 9 the bank pays a check for \$20,000 against the account. Now \$10,000 remains in the account. On January 11, the January 5 check is returned unpaid. The bank is treated as having paid the January 9 check against the January 2 cash deposit and the January 5 check deposit. If the bank meets the good faith and without notice tests of U.C.C. § 3-302, the bank is a holder in due course and is entitled to enforce the January 5 check against the drawer free of any defenses the drawer might have against the payee. The bank can enforce the January 5 check even though, when the check was returned, the bank could have charged the check against the \$10,000 balance still in the account.

Even in the absence of § 4-208 and § 4-209, a bank which allowed a depositor to draw against uncollected funds would seem to have given value under U.C.C. § 3-303 and could, therefore, be a holder in due course. However, in the absence of § 4-208 and § 4-209, courts might not use the first-in, first-out rule to determine whether a bank made payments against uncollected checks.

²⁷ Bank checking account agreements typically state that items are taken for collection only and that if the items are returned unpaid the bank will charge them to the customer's account. Even in the absence of such a contract provision, U.C.C. § 4-212 (NUFC 424) gives a bank the right to charge back unpaid checks.

find that he will not be able to cover an overdraft created when the bank permitted him to draw against uncollected funds. In those circumstances, it seems appropriate to take away negotiability, force the bank to assume the credit risk as to its depositor which the bank took in the first place, and give the drawer the right to assert defenses against the bank.²⁸

Occasionally the bank, although aware that its depositor is near financial collapse, tries to keep the depositor in business as long as possible by paying the depositor's overdrafts. The bank may be trying to keep the depositor in business to preserve a customer who in the past has been a good customer and may be so again. The bank also may have loans out to the depositor and will be trying to keep the depositor in business at least long enough for the depositor to pay back the loans. In this situation, the bank, like the transferee of a promissory note from a dealer, knows more about the depositor's problems and lack of reliability than does the usual consumer who has paid for goods by check and the bank should not be able, any more than as the transferee of a negotiable note, to claim holder in due course status at the expense of a consumer with a defense against the payee-depositor of the check.

A few cases will occur in which the payee of a consumer check will transfer the check to a nonbank. Conceivably NUPC should accord the nonbank transferee holder in due course status. However, such transferees already take the risk that the drawer will not have sufficient funds on deposit to cover the check and will be unable to pay it. The risk that the consumer-drawer also will have a defense to the check is a relatively insignificant additional risk. Just as in the case of banks, the transferee typically takes the check not on the credit of the consumer but on the credit of the person from whom the transferee takes the check. It would seem reasonable, therefore, to deny holder in due course status to nonbank transferees of consumer checks.

II. RECOVERY OF PAYMENTS MADE ON NON-NEGOTIABLE CHECKS

The argument thus far is that consumer-drawers of checks who discover a defense to the debt in time to stop payment on the checks should be able to do so free of due course claims of subsequent transferees. However, a further and somewhat more troublesome problem arises. Suppose the consumer does not stop payment on the check but later claims that, because of the defense, the consumer is entitled to recover from the depository bank, or another holder, the money paid out on the check. Is the consumer entitled to recover the payment? Or can the transferee of the check retain the check's proceeds once received, even though the transferee would not have prevailed in a suit against the drawer on the check? This issue exists today, at least theoretically,

²⁸ See Rosenthal, *supra* note 20, at 382-94.

as to nonholders in due course who receive payment of checks. The issue, however, will become of much greater significance in a system in which large numbers of checks are not negotiable. While the author did not find any check cases specifically addressing the issue,²⁹ a small number of cases involving the analogous situation of the assignee of an ordinary contract exists.³⁰

In several cases obligors have been able to recover, on mistake theory, payments made to assignees where, when the obligor made the payment, the assignor had breached the contract with the obligor but the obligor had not yet learned of the breach.³¹ On the other hand, several other cases have held that an assignee is no different than any other transferee of money and is not obligated to return money collected under the assignment even though he could not have recovered the money in an action against the obligor. Some of those courts reason that if the obligor had paid the money directly to the assignor who had then paid a creditor with the money, the obligor clearly could not recover the money from the creditor and that the result should not change merely because the creditor has an assignment and the obligor makes payment directly to the creditor as assignee.³² In other cases the courts have said that an obligor may recover payments made to an assignee only on an unjust enrichment theory and that the assignee is not unjustly enriched by receiving payment of a claim for which the assignee has already given value.³³ Palmer points out that the weakness in that argument is that if the obligor had not paid, the assignee's position as good faith purchaser for value would not have enabled the assignee to recover free of the obligor's defense.³⁴ However, the Restatement of Restitution provides that an assignee of a non-negotiable instrument who paid value therefore and has received payment from the obligor is under no duty to make restitution to the obligor although the obligor had a defense to

²⁹ In *Crest Fin. Co., Inc. v. First State Bank of Westmont*, 37 Ill.2d 243, 226 N.E.2d 369 (1967), however, the court, without discussing the issue, assumed that a drawee could recover sums a nonholder in due course collected on a check. However, the court found the transferee of the check to be a holder in due course.

³⁰ A transferee of commercial paper who does not have due course rights occupies essentially the same position as an ordinary assignee with respect to the right to take free of claims and defenses of the obligor. U.C.C. § 3-306 provides that a nonholder in due course takes the instrument "subject to . . . all defenses of any party which would be available in an action on a simple contract. . . ." NUPC continues that rule in NUPC 103.

³¹ *Munson v. De Tamble Motors Co.*, 88 Conn. 415, 91 A. 513 (1941); *J.I. Case Credit Corp. v. Andreason*, 90 Idaho 12, 408 P.2d 165 (1965). See 4 A. CORBIN, CONTRACTS § 895 (1951).

³² *Midtown Bank of Miami v. Travelers Indem. Co.*, 366 F.2d 459 (5th Cir. 1966); *California Bank v. U.S. Fidelity & Guar. Co.*, 129 F.2d 751 (9th Cir. 1942).

³³ See the cases discussed in 3 G. PALMER, LAW OF RESTITUTION § 16.7 (1978). Apparently very few cases exist; Palmer cites less than 10.

³⁴ *Id.*

payment, if the transferee made no misrepresentation and had no notice of the defense.³⁵

Whatever its merits generally, the Restatement rule seems preferable as to checks. It would be particularly unsettling in the business world if the drawer of a check long since paid could recover the payment from a good faith transferee based on the assertion that the drawer had a defense against the payee. Also, it is, as noted above, somewhat anomalous to require an assignee to return a payment of money when a person who received the same payment without an assignment would not have to return it. Nevertheless, as noted, some case law authority inferentially supports the proposition that transferees of non-negotiable checks who receive payment on those checks remain subject to the drawer's claims or defenses and can be required to return to the drawer the money collected.³⁶

Section 103(1)(b) of NUPC, which deals with rights of transferees who do not have due course rights, contains language which the Committee probably intended to preclude a drawer of a non-negotiable check from recovering the funds from a remote holder once the check has been paid.³⁷ That section states that a holder who does not have due course rights, until the check is finally paid, is subject to all defenses and counterclaims of any person which would be available on a contract.

³⁵ RESTATEMENT OF RESTITUTION § 14(2) (1937).

³⁶ See cases cited *supra* note 31. See also the cases cited in Annot., 41 A.L.R. 588 (1924). The author of the annotation states that the general rule is that payments made by mistake can be recovered if the recovery will not injure the transferee. The author, however, cites only five cases other than forged payee endorsement cases.

The rule of the Restatement of Restitution 14(2) applies only to defenses of the obligor; it does not deal with third-party claims arising out of forgery of a payee's signature. The Federal Trade Commission rule, *supra* note 23, provides that "recovery of the debtor hereunder shall not exceed amounts paid by the debtor hereunder." The FTC language could be read as a contractual promise by the assignee that the assignee will be subject to suit for breaches by the assignor to the extent of payments the assignee actually receives under the contract. In the peculiar world of consumer credit contracts, recovery from the assignee of payments already made may be justified.

The 1974 Consumer Credit Code provides that the assignee is subject to defenses to the extent of payments due after the assignee learns of the defense. Under the Consumer Credit Code rule the assignee could recover from the consumer any payments which came due before the assignee received notice of the defense, free of the defense, even though the assignee brings suit after the assignee receives notice. U.C.C.C. § 3.404 (1974). The assignee thus has a greater right under U.C.C.C. than he would have under the common law rules of assignment. See *infra* note 68.

³⁷ 103: *Rights of Claimant Without Due Course Rights*

(1) A claimant on an authorized draw order or payee of an authorized pay order may transmit the order to another person, may discharge the order, or may enforce payment of the order in its own name.

(2) The rights of any claimant on an authorized order which is initiated by a consumer drawer or which does not state within the order that it is "subject to due course rights," as well as the rights of any claimant not entitled to due course rights under Section 104 and 106, are subject to:

The NUPC language, read literally, says that defenses and counterclaims are not available after payment. Since defenses and counterclaims are irrelevant if the obligor has paid the obligation, such language has meaning only if it is interpreted to say that money, once paid, cannot be recovered on the basis of the former defense or counterclaim. If this interpretation is the Committee's intent, however, the Committee could make the language clearer. In any event, the section does not go far enough. NUPC 103(2)(b), in which the language appears, applies only to defenses and counterclaims; it does not apply to claims. Two(a) of the section, which does apply to claims, is not qualified by the language "until finally paid." If circumstances exist for which the obligor could rescind the transaction, such as fraud or material breach of contract, then the obligor would have a right to demand the return of the check, and, therefore, a claim on it. That claim might permit the obligor to sue for return of any proceeds actually received by a person who would have been subject to the claim prior to his collection of the check.³⁸

The above discussion points out that the case law is divided as to whether an obligor can recover payments made to an assignee based on the fact that the obligor had a defense to the payment. Since the issue will arise frequently as to non-negotiable checks, NUPC should state a definite rule. That rule should be that of the Restatement of Restitution.³⁹ NUPC, therefore, should contain a provision reading substantially as follows:

A transferee for value of an order, whether or not he has due course rights, having received payment of the order, is under no obligation to make restitution to the drawer even though the drawer had a defense to the payment or a right to rescind the transaction, if the transferee made no misrepresentation and had no notice of the defense or claim.

III. THIRD PARTY CLAIMS

If a transferee of a negotiable instrument is not a holder in due course, he is subject, it is generally assumed, not only to the defenses

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- (a) all valid claims to the order on the part of any person; and
 - (b) until finally paid, all defenses and counterclaims to the extent of the order as drawn, including setoff, of any person which would be available on a contract, including want or failure of consideration or non-performance of any condition precedent, non-delivery, or delivery for a special purpose.

(3) The claim of any person to an authorized order is not available as a defense to any party liable thereon unless the person itself defends the action for such party. NUPC § 103 (1982).

³⁸ See *infra* notes 44, 45 and accompanying text.

³⁹ Since the American Law Institute approved the Restatement of Restitution and must approve NUPC, the "3-4-8" Committee would at least have to justify to the Institute a departure from the Restatement position.

and claims of the drawer of the check, but also to claims of third parties.⁴⁰ In the ordinary case this is appropriate: the failure of the person to be a holder in due course will be because he did not give value, or lacked good faith, or was on notice of a claim or defense. In such a case, the transferee, because of his own lack of merit, is not entitled to take free of prior claims. In traditional terms such a transferee is not a good faith purchaser for value and therefore is not entitled to protection against even unknown interests of prior persons.⁴¹

Under the Commercial Code and under the prior Negotiable Instruments Law (N.I.L.), one situation exists, however, in which the subsequent transferee is not a holder in due course, not because of his own fault, but because of the nature of the prior wrong: the case of the forged endorsement which is necessary for negotiation. Under well-established theory, no one can be a holder under a forged endorsement of order paper,⁴² and since one must be a holder to be a holder in due course,⁴³ a person who takes under a forged endorsement is not a holder in due course. The holder whose endorsement is forged, therefore, can recover a check from the person in whose hands it rests. If the check has been paid, the holder can recover the check's face amount in conversion theory from the drawee⁴⁴ or any person who took the check after the forgery.⁴⁵

⁴⁰ Under U.C.C. § 3-306 a person who is not a holder in due course takes the instrument "subject to . . . all valid claims to it on the part of any person." NUPC 103(2)(a) continues the rule.

⁴¹ Arguably notice of one possible defense or claim does not prevent a transferee from taking free of an entirely different claim or defense. Suppose, for example, that Transferee knows that Trustee transferred to him a check payable to the trust, not in payment of a trust debt, but in payment of Trustee's own debt. That knowledge prevents Transferee from being a holder in due course. Suppose, however, that Trustee was not breaching his trust, but that the issuer of the check has a defense. Is the transferee subject to that unrelated defense? Under the N.I.L. some cases held that the transferee could be a holder in due course except in regard to claims and defenses of which the transferee had notice. See W. BRITTON, *BILLS & NOTES* § 117 (2d ed. 1961). Under the Commercial Code, however, the general assumption is that "for most purposes there need be no connection between the defense or claim which the party on the instrument is attempting to assert and the flaw which allegedly deprives one of holder in due course status." J. WHITE & R. SUMMERS, *supra* note 23, at 568. The Code states that a nonholder in due course takes subject to all valid claims of any person and subject to all claims and defenses which would be available on a simple contract, and certainly supports the White and Summers position. U.C.C. § 3-306. NUPC 103 continues the U.C.C. rule.

⁴² U.C.C. §§ 1-201(20); 3-202(2); 3-404; 3-302.

⁴³ U.C.C. § 3-302.

⁴⁴ Under U.C.C. § 3-419(1)(c), a drawee who pays an instrument over a forged endorsement is guilty of conversion.

⁴⁵ An unendorsed check is subject to the same property and conversion rules as chattels. Under general common law rules, any person who wrongfully intervenes with another's ownership rights in chattels is guilty of conversion and must pay the value of the chattels to the owner. A thief is guilty of conversion, and so is the innocent subsequent purchaser from the thief. See generally W. PROSSER, *THE LAW OF TORTS* § 4 (4th ed. 1971). Prosser states:

The rules as to takers under forged endorsements are of long standing and are common knowledge in the business world. Nearly everyone knows that if a payee does not endorse a check, or endorses it restrictively,⁴⁶ the payee is protected against loss through theft of the check. Conversely, it is common knowledge that if a payee endorses a check in blank⁴⁷ and nonrestrictively, and the check is stolen, subsequent transferees can take free of the true owner's claim or defense of theft.⁴⁸

The forgery rules as they have developed as to checks and other commercial paper make good sense. If unendorsed checks could be stolen and passed on to holders in due course who took free of the true owner's interests, checks would lose a good deal of their value as a medium of payment. Checks could be stolen from the mails, from mail rooms, or from offices. Payment by check would be nearly as risky as payment by cash. Only a naive or absurdly risk-prone person sends cash by mail: if checks were as risky as cash, paying bills would become a great deal more expensive and less convenient than at present. On the other hand, if a payee of a check endorses it in blank, the payee gives any thief the ability to appear to be the rightful owner of a check properly acquired. Similarly, if a payee receives a bearer check and fails to endorse it specially⁴⁹ or restrictively, the payee gives a thief the power to appear to

[A] bona fide purchaser of goods from one who has stolen them, or who merely has no power to transfer them, becomes a converter when he takes possession to complete the transaction. The courts of New York and those of two or three other states, have held that such possession is not in itself a sufficiently serious interference with the owner's rights to amount to conversion, so that the purchaser is liable only when he refuses to return the goods on demand. But the great weight of authority regards the mere acquisition of the goods under such circumstances as in itself an assertion of an adverse claim, so detrimental to the dominion of the owner that it completes the tort, and no demand is required. (footnotes omitted)

⁴⁶ See U.C.C. § 3-205. An endorsement is restrictive if it is conditional, or prohibits further transfer of the instrument, or includes terms which signify that the instrument is for deposit or collection only, or states that the instrument is for the benefit or use of the endorser or another person. By far the most common restrictive endorsement is "For deposit only." When Payee endorses a check "For deposit only, Payee," he puts the world on notice that he expects the check to be deposited in a bank to his account. If the check is used in any other way, the transferees cannot be holders in due course. See U.C.C. § 3-206(3). NUPC 108 continues the rule of U.C.C. § 3-206(3).

⁴⁷ U.C.C. § 3-203(2) reads: "An indorsement in blank specifies no particular endorsee and may consist of a mere signature. An instrument . . . indorsed in blank becomes payable to bearer and may be negotiated by delivery alone until specially indorsed."

⁴⁸ Under U.C.C. §§ 1-201(20), 3-202(2), 3-404, and 3-302, any person in possession of a check payable to bearer or endorsed-in-blank can be a holder. If the holder also takes in good faith, without notice, and for value, he can be a holder in due course. U.C.C. § 3-302. A holder in due course takes free of all claims of prior parties. U.C.C. § 3-305.

⁴⁹ The holder of a check payable to bearer can specially endorse it by writing on the back, "Pay to Holder," and signing it. Thereafter, Holder's additional signature as endorser is necessary to a negotiation. U.C.C. § 3-204(1). Similarly, if Holder receives a check endorsed-in-blank, he can convert the blank endorsement into a special endorsement by writing "Pay to Holder" above the endorsement. U.C.C. § 3-204(3).

be the rightful owner of the check. Since no holder of a check is required to endorse the check in blank and no holder of a bearer check is required to let it remain a bearer instrument, one who endorses a check in blank or fails to appropriately endorse a bearer check and so enables a thief to appear to have good title should lose to subsequent holders in due course.

It is beyond question but that a transferee of a consumer check under NUPC should not get more rights than the transferee of a negotiable check. The rules protecting a holder who does not endorse a check or who endorses it restrictively, therefore, should apply to consumer checks as well as to others, and they do.⁵⁰

The difficult question, however, is whether a transferee of a consumer check, who would be a holder in due course and take free of third party claims except for the fact that he took a non-negotiable check rather than a negotiable one, should be subject to those third-party claims.⁵¹ The issue will arise in two standard situations in addition to theft. First, the payee or other holder of the check will entrust it to an agent or employee for some special purpose, such as deposit, and the agent will then use the check for a different, unauthorized purpose. Second, the payee or other holder will be induced by fraud to endorse the check over to a transferee. In all three cases, the issue which arises is whether a subsequent good faith purchaser for value takes free of the

⁵⁰ See *supra* note 47.

⁵¹ NUPC 103, following U.C.C. § 3-306, provides that a transferee who does not have due course rights takes "subject to the valid claims to the order on the part of any person." Under a literal interpretation of NUPC 103, a transferee of a consumer check, who necessarily has no due course rights (NUPC 104), would be subject to the claims of the owner who lost the check by fraud, theft, or improper conduct of an agent even though the owner had endorsed the check in blank. A transferee subject to a claim of the true owner is subject to conversion liability if he transfers the check to someone else or receives payment of it. See J. WHITE & R. SUMMERS, *supra* note 23, at § 15-4; Annot., 44 A.L.R.2d 929 (1955).

Checks are subject to the U.C.C. and NUPC only if they meet certain requirements: they must be signed by the drawer, contain an unconditional order to pay a sum certain in money, be payable on demand or at a definite time, and contain no other order or power (except as authorized by the acts). U.C.C. § 3-104. NUPC continues those rules with similar language in NUPC 10. Therefore, neither act covers an order which says "pay to X \$1,000 when my ship comes in" since the order is not payable at a definite time. Since neither act covers the order, the rules of the act applicable to persons who are not holders in due course would not apply. If neither act applies, the common law determines whether good faith transferees for value take free of unknown claims of third parties.

Under both acts, however, there are instruments as to which there can be no holder in due course, but which are otherwise subject to the rules of the acts. U.C.C. § 3-805 makes Article 3 applicable to instruments which are otherwise negotiable except that they do not contain the words "bearer" or "pay to order of." As the section says, however, there can be no holder in due course of such an instrument. If the transferee cannot be a holder in due course but is otherwise subject to the rules of Article 3, under U.C.C. § 3-306 the transferee takes the instrument subject to all claims to it. Similarly, under NUPC a consumer check which meets the formal requirements of NUPC 10 is subject to all of the NUPC rules except that no transferee of the check can have due course rights.

the interest of the true owner-holder who lost possession of the check.⁵²

The three ways just mentioned of possibly losing title to property: theft, wrongful conduct of a person to whom the property is entrusted, and fraudulently induced transfer, are commonly recognized categories of wrongdoing as to chattels. In the following pages I will argue that the good faith purchaser for value⁵³ of a non-negotiable consumer check should be in at least as good a position as the buyer of chattels as against the true owner.

IV. ENTRUSTING

Occasionally the owner of goods gives possession of them to another and that other, inconsistently with the owner's rights, purports to sell the goods to a good faith purchaser. The basic common law rule in the entrusting case is that the non-owner in possession lacks the power to transfer good title to the goods and that the true owner can recover the goods from a good faith purchaser.⁵⁴ The judicial attitude supporting the common law rule is reflected in the following statement of the Illinois Supreme Court in a 1925 case:

Possession is one of the indications of title, but possession may be delivered by the owner to a lessee, a bailee, an agent, or a serv-

⁵² Nothing in the present NUPC indicates that the drafting committee has considered the question whether a subsequent good faith purchaser of a non-negotiable instrument takes free of prior third-party claims. The discussion of the abolition of due course rights in the comments to NUPC 103 talks only about drawers' claims and defenses. Some of the language of NUPC infers that a transferee of a properly endorsed instrument becomes the owner of the instrument whether or not the instrument is subject to due course rights. See NUPC 52(1) which provides that a "claimant is a person to whom an authorized order has been transmitted." An authorized order is one which has been properly endorsed. NUPC 54(1). Under NUPC 205(1), "[a]ny person which gives value on or for an order to any person except the claimant [read holder] or an account institution transmitting or receiving funds on its behalf is liable to the claimant [holder]." The language suggests that when a non-negotiable instrument is endorsed and stolen, the thief or any transferee from the thief becomes the claimant and payment must be made to him. If so, the person from whom the instrument was stolen loses ownership of it. This result runs directly contrary to the rule stated in NUPC 103 that a person who lacks due course rights takes the order subject to the valid claims of all persons.

⁵³ If NUPC is modified in accordance with the position taken in this article it may be better not to use the term "good faith purchaser for value" in the statute. The statute could achieve the results for which this article argues by providing that persons with due course rights do not take free of consumer-drawer claims and defenses, but do take free of claims and defenses of other prior parties. Other ways of achieving this result without using the good faith purchaser language probably exist. This article, however, uses the term "good faith purchaser for value" since the literature discussing similar issues as to goods and choses in action employs the term.

⁵⁴ See Warren, *Cutting Off Claims of Ownership Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 469, 469-71 (1963). See also Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1057-59 (1954). These two articles contain excellent discussions of the development of the law of good faith purchase as to goods, instruments, and documents of title.

ant. Owners of chattels must frequently entrust others with their possession, and the affairs of men could not be conducted unless they could do so with safety, so long as the possession of the chattel is not accompanied by some indicium of ownership or the right to sell.⁵⁵

However, there are two situations in which the person to whom goods are entrusted can convey good title to a good faith purchaser for value. The first is that of the owner who allows the possessor to have or exhibit some "indicia of ownership" in addition to mere possession. In *O'Connor v. Clark*,⁵⁶ a lessor of a wagon, prior to leasing it to George Tracy, painted on the wagon "George Tracy, Piano Mover." Tracy sold the wagon. The court said that:

[W]here the owner has so acted with reference to his property as to invest another with such evidence of ownership or apparent authority to deal with and dispose of it, as is calculated to mislead and does mislead a good faith purchaser for value . . . the principle of estoppel applies and declares that the apparent title or authority for the existence of which the actual owner was responsible, shall be regarded as the real title or authority Strictly speaking, this is merely a special application of the broad equitable rule that where one of two innocent persons must suffer loss by reason of the fraud or deceit of another, the loss should fall upon him by whose act or omission the wrongdoer has been enabled to commit the fraud.⁵⁷

The other situation is that of entrusting possession of the goods to a merchant who deals in goods of that kind. Section 2-403(2) of the Uniform Commercial Code provides that entrusting possession of goods to a merchant who deals in goods of that kind gives the merchant power to transfer all rights of the entrustor to a buyer in the ordinary course of business.⁵⁸ Under U.C.C. 2-403(2), an owner who delivers goods to a mer-

⁵⁵ *The Sherer-Gillett Co. v. Long*, 318 Ill. 432, 435, 149 N.E. 225, 226 (1925).

⁵⁶ 170 Pa. 318, 32 A. 1029 (1895). The rule of "indicia of title" is not codified in the Uniform Commercial Code. U.C.C. § 2-403(1) merely states: "A purchaser of goods acquires all title which his transferor had or had power to transfer. . . ." The comment to that section, however, recognizes the possibility of loss of title by estoppel.

[T]he policy of this Act expressly providing for the application of supplementary general principles of law to sales transactions wherever appropriate joins with the present section to continue unimpaired all rights acquired under the law of agency or of apparent agency or ownership or other estoppel, whether based on statutory provisions or on case law principles.

U.C.C. § 2-403(1) comment 1. A recent case in which the court held an owner estopped from asserting his title as against a good faith purchaser from a bailee is *Tumber v. Automation Design & Mfg. Corp.*, 130 N.J. Super. 5, 324 A.2d 602 (1974).

⁵⁷ 170 Pa. 318, 321, 32 A. 1029, 1030.

⁵⁸ See *Gilmore*, *supra* note 54, at 1057-59 (discussion of factors acts). The rule represents a continuation and broadening of the "factors acts" adopted in many states in the

chant for repair or storage may have his ownership rights cut off if the merchant sells the goods. The owner loses his rights, however, only as against a buyer in the ordinary course of business.⁵⁹

Having reviewed the entrusting rules in relation to goods, we turn now to a consideration of likely fact situations in relation to non-negotiable checks in an attempt to make a judgment whether the true owner or a subsequent good faith purchaser for value should suffer the loss in entrusting cases. It has already been argued that it would be intolerable to permit thieves to pass good title to checks payable to order or restrictively endorsed.⁶⁰ Accordingly, under NUPC, as under present law, transfer of an order check requires an endorsement, whether or not the check is negotiable.⁶¹ Therefore, the entrusting issue will arise only if the check is payable to bearer or endorsed-in-blank. Consider the following hypothetical situation. Payee-doctor endorses non-negotiable checks in blank and asks Employee to take the checks to X bank and deposit them. Employee takes a single \$1,000 check from the packet of checks and the next day endorses it over to Car Dealer in payment for a car delivered at the time. Assume Car Dealer is in good faith and without notice of any defect in Employee's title to the check. If the check were negotiable, the law, currently and under NUPC, would grant the car dealer holder in due course status, free of the payee's claim.

Since the checks are non-negotiable, however, transferees do not have due course rights and under the NUPC and Uniform Commercial Code rule, are subject to all claims to the instrument.⁶² Under that rule the payee could recover the check or its proceeds from the person to whom the employee transferred it and all subsequent transferees. If, however, non-negotiable checks can still pass hand to hand like chattels, and possession of the check is essential to its collection,⁶³ good faith purchaser rules similar to those applicable to chattels arguably should apply to non-negotiable checks.

nineteenth century. Those acts provided that an agent for sale who had possession of the principal's goods could pass good title to a good faith purchaser even though the agent sold inconsistently with his authority.

⁵⁹ U.C.C. § 1-201(9). A buyer in the ordinary course of business is one who buys in good faith and without knowledge that the sale violates the rights of any third-party owner or holder of a security interest from a merchant who deals in goods of the kind.

⁶⁰ See *supra* text accompanying notes 46-50.

⁶¹ NUPC 54(1).

⁶² NUPC 103(1)(a). See *supra* notes 51, 52.

⁶³ NUPC continues the rule of U.C.C. § 3-505(1)(d) that the person to whom a draw order including a check is presented for payment may demand surrender of the order when paying the check. That rule applies to checks whether or not they are negotiable. NUPC 412(5)(b)(iv). No doubt the rights evidenced by a non-negotiable check are locked up in the check, so that transfer of the right requires transfer of the check itself. A non-negotiable check is an instrument like that defined in U.C.C. § 9-105(1) as "any . . . writing which evidences a right to the payment of money . . . and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment."

If an entrusting rule similar to those of U.C.C. 2-403(2) applies to non-negotiable checks, what kind of trustee should be viewed as analogous to the U.C.C. 2-403(2) "person who deals in goods of that kind?" One might conclude that only banks "deal in" checks, and that the entrusting rule should apply only to wrongful transfers by banks. Wrongful transfer by banks, however, is a non-problem, and, if the entrusting rule is so limited, it would not be worth bothering with. The entrusting rule could be made applicable to banks and all businesses generally on the theory that all businesses "deal in" checks. Such a rule probably would cover some cases since it occasionally must happen that a business is entrusted with a check endorsed-in-blank. Businesses acting as trustees or agents might hold such checks. The rule then would be that a check owner who entrusted a non-negotiable check endorsed-in-blank to a business would lose title to it if the business transferred the check to a good faith purchaser for value, but would not lose title if the check were entrusted to a nonbusiness (a consumer). Finally, one might conclude that every person "deals in" checks for the purpose of entrusting rules and has power to transfer to a good faith purchaser free of the entrustor's interest: This position is, I believe, the correct one.

A person who entrusts another with a check endorsed-in-blank should be treated as giving the trustee indicia of title so that the entrustor is estopped to deny that the trustee had power to pass title to a good faith purchaser for value. While merely giving a person possession of chattels ordinarily has not been sufficient to create an estoppel against the entrustor, the situation as to checks, negotiable or non-negotiable, is different. There is no reason for a person to transfer a bearer check or a check endorsed-in-blank to another while intending to retain title. Checks are not usable chattels which another might borrow or lease; checks do not have to be turned over to another for repair; checks do not have to be given to another for storage. The most common reason for entrusting a check to another is to initiate the bank collection process. If that is the purpose, as every businessman knows, the way to keep the person entrusted with the checks from running off with the money is to endorse the checks for "deposit only." Since the use and transfer of checks is a pervasive part of current American practice, the law should treat every person as a "merchant who deals in checks," and on entrusting and indicia of title principles, persons who entrust to another bearer or endorsed-in-blank checks, negotiable or not, should lose to subsequent good faith purchasers for value.⁶⁴

⁶⁴ A number of precode cases applied indicia of title and estoppel theory to cut off the rights of transferors of negotiable instruments as against transferees who were not holders in due course but who, nevertheless, were not on notice of the particular claim. Courts often used estoppel theory to protect a taker of an instrument after it matured from the claims of a prior holder who had been induced by fraud to transfer the instrument. Under both the N.I.L. and the U.C.C., a transferee who takes with notice that the instrument is overdue can-

Arguably the entrusting rules should operate only against nonconsumers. Several reasons exist, however, why no distinction should be drawn. Consumers, by and large, know the risks the holder of an endorsed-in-blank check runs when the holder gives the check to another. The law should therefore demand that consumers guard against such possible imposition on subsequent parties. (Frequently the subsequent good faith purchaser will also be a consumer.) Further, if the law provides a special rule for consumer transferors, does the law apply only to consumer checks or does it also apply to negotiable business checks? Under the present scheme of NUPC, transfer to a person with due course rights cuts off the consumer-holder's rights as to a negotiable check.⁶⁵

V. FRAUDULENTLY INDUCED TRANSFER

If the holder of a consumer check has been induced by fraud to endorse the check to a wrongdoer, should the holder be able to rescind the transaction as against a subsequent good faith purchaser for value? Even if one did not agree that entrusting rules should cut off claims of the true owner as against good faith purchasers of non-negotiable checks, one might conclude that in the special case of a transfer induced by fraud, a subsequent transfer to a good faith purchaser should cut off the claim. Or, on the other hand, one might conclude, quite to the contrary, that even though a person who entrusts his checks to another without endorsing them specially or restrictively should lose to a subsequent good faith purchaser for value, one who is induced by another's fraud to transfer a non-negotiable check should not. Why might one reach such opposite conclusions? Answer: the situation falls within one of the "time-warps" of the law. Which conclusion is drawn depends upon which of two possible situations are thought to be analogous. Under the voidable title rules applicable to sales of goods, a person who, induced by the fraud of a buyer, sells and transfers possession of goods to the buyer, gives the buyer power to transfer good title to a good faith purchaser for

not be a holder in due course. However, while the fact that an instrument is overdue might suggest that the maker or drawer has a defense, it does not suggest that a prior holder has been induced to transfer the instrument by fraud. Therefore, many courts protected aftermaturity transferees against claims of prior holders. *See, e.g., Justice v. Stonecipher*, 267 Ill. 448, 108 N.E. 722 (1915) (court held that the prior holder voluntarily transferred the instrument to the wrongdoer and thus held him out as owner).

Professor Chafee argued in his famous article that a transferee who would be a holder in due course except for the fact that he took overdue paper should be subject to defenses of the drawer or maker, but should not be subject to claims of ownership of prior transferors. Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104 (1918). *See Warren, supra* note 54, at 480-82.

⁶⁵ NUPC 104.

value.⁶⁶ Under the law of negotiable instruments, however, a drawer of a check who is induced to issue a check to a payee through the fraud of the payee retains the defense of fraud against anyone not a holder in due course.⁶⁷ The commercial paper rule is merely a special application of the universally recognized common law rule that assignees of contract rights take the rights subject to whatever defenses the obligor has against the assignor.⁶⁸

If the goods rule applies to an endorser of a non-negotiable check but a drawer of a non-negotiable check retains the defense of fraud as against subsequent good faith purchasers, results will vary in what may seem to be an irrational way. If Payee of a non-negotiable check deals with the perpetrator of the fraud before the check is deposited and endorses the check over to the fraudulent party who then transfers it to a good faith purchaser for value, the good faith purchaser takes free of Payee's claim. On the other hand, if Payee does not deal with the fraudulent party until Payee deposits the check and Payee issues his own check to the fraudulent party, the good faith purchaser for value of the check takes the check subject to the defense of fraud.

Since the transferee of a non-negotiable instrument is simply a special kind of assignee, an examination of the rules applicable to ordinary assignments is instructive as to justification for different results. Many writers argue that while an assignment to a good faith purchaser for value does not cut off an obligor's defenses, the rights of an assignee who is fraudulently induced to further assign are cut off if the fraudulent sub-assignee reassigns to a good faith purchaser for value.⁶⁹ That is the

⁶⁶ U.C.C. § 2-403 codifies the voidable title rule. A person who is induced to transfer title by fraud or deceit has transferred title, but, because of the fraud or deceit, can rescind the transaction and recover the goods. The fraudulent transferee thus has received a voidable title. The right to rescind and reclaim the property is lost when the wrongdoer transfers the goods to a good faith purchaser for value. See Warren, *supra* note 54, at 475-78.

⁶⁷ U.C.C. § 3-306(b), (c). NUPC 103(1)(b) provides that a person without due course rights is subject to "all defenses, and counterclaims to the extent of the order as drawn, including setoff, of any party which would be available on a simple contract, including want or failure of consideration or non-performance of any condition precedent, non-delivery, or delivery for a special purpose."

⁶⁸ RESTATEMENT (SECOND) OF CONTRACTS § 336(1) (1981). Subsection (2) of § 336 also repeats the general American rule that the obligor can assert against the assignee any defense or claim that the obligor has against the assignor and which accrued before the assignor received notice of the assignment. The obligor has the right to assert claims or defenses even though the defense or claim arose out of dealings between the obligor and the assignor which are unrelated to the right assigned.

The Commercial Code, in § 9-318(1), states the rules contained in the Restatement somewhat more simply and clearly:

(1) Unless an account debtor has made an enforceable agreement not to assert defenses or claims arising out of a sale as provided in Section 9-206 the rights of an assignee are subject to

(a) all the terms of the contract between the account debtor and

position taken by the Restatement of Contracts. Section 336 thereof contains the rule universally applied in this country that an assignee can acquire no greater rights against the obligor than the assignor had and is subject to defenses which the obligor has against the assignor.⁷⁰ On the other hand, section 343 provides that an assignee who gives value and becomes an assignee in good faith and without notice of a third-party claim, takes free of the right of the third party to assert a lien or right of rescission.⁷¹

Under the Restatement rules, a person who is induced to enter into a contract by fraud can assert the fraud as a defense against a subsequent good faith assignee for value. If a person by fraud is induced to transfer his rights under an existing contract, however, and the assignee then further transfers the rights to a sub-assignee who is in good faith and gives value, the sub-assignee takes free of the defrauded assignor's rights. The same rule also appears in the Restatement of Restitution and the Restatement of Trusts.⁷²

The case law is not entirely consistent with the Restatement position. While there is case support for the Restatement position, there are also a number of cases holding that a good faith assignee for value takes subject to third-party claims.⁷³ However, even though the case law is divided as to the rights of the good faith assignee for value of ordinary contract rights, practically all cases hold that a good faith assignee for value who receives possession of a piece of paper evidencing choses in action having tangible form (*e.g.*, certificates of stock, insurance policies, non-negotiable instruments, or tax certificates) takes free of third-party

assignor and any defense or claim arising therefrom; and

(b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.

⁶⁹ Ames, *Purchase for Value Without Notice*, 1 HARV. L. REV. 1 (1887); 4 A. CORBIN, CONTRACTS § 900, at 606 (1951).

⁷⁰ See *supra* note 68.

⁷¹ RESTATEMENT (SECOND) OF CONTRACTS § 343 (1981). Section 343 is a continuation of RESTATEMENT (FIRST) OF CONTRACTS § 174 (1932). See RESTATEMENT (SECOND) OF CONTRACTS § 343 comment b (1981).

⁷² The rule of RESTATEMENT (SECOND) OF CONTRACTS § 343 is also found in RESTATEMENT OF RESTITUTION § 172 (1937), and RESTATEMENT (SECOND) OF TRUSTS §§ 284, 285 (1959).

⁷³ Corbin cites 19 cases holding that the good faith assignee for value from the wrongdoer takes free of the claim of the true owner. He cites 14 cases holding that the good faith assignee does not take free of the true owner's claim. 4 A. CORBIN, CONTRACTS § 900, at 606-07 nn.40, 41 (1951). See also 2 S. WILLISTON, CONTRACTS § 438, at 1269 n.6 (2d ed. 1936); 4 A. SCOTT, THE LAW OF TRUSTS § 284.1, nn.4, 5 (3d ed. 1967); Note, *Latent Equities*, 20 U. CHI. L. REV. 692 (1953).

Gilmore, for reasons known only to him, in his famous article on good faith purchase, ignores the first Restatement of Contracts § 174 and the substantial case law holding that a good faith assignee for value takes free of latent claims of prior parties. Gilmore, *supra* note 54, at 1068.

claims.⁷⁴ What is the policy justification for treating original obligors and subsequent third-party claimants differently as against good faith purchasers for value? Specifically, in the context of NUPC, is there any justification for treating differently the case in which *B*'s fraud induces *A* to make out a non-negotiable check to *B*, and the case where *B*'s fraud induces *A* to endorse to *B* a non-negotiable check payable to *A*, when, in either case, *B* subsequently transfers the check to *C* who takes in good faith, for value, and without notice of the fraud?

In one of the first cases to deal with the issue whether a good faith assignee takes free of unknown claims of third parties, Chancellor Kent argued that even though a good faith assignee for value without notice did not take free of defenses of the obligor, he should take free of unknown third-party claims since, while the assignee could make inquiry of the obligor as to defenses, he could not discover all third parties who might have a claim.⁷⁵ That reasoning might be valid in some cases, but it does not cover transferors of instruments who have endorsed the instruments, since the endorser's name is known, and, with some diligence, the endorser can be found and inquiry made. In his famous article on the subject, Ames argued that the good faith assignee for value should take free of unknown third-party claims on exactly the same ground that protects a bona fide purchaser of chattels or lands from such claims: equity does not require a good faith purchaser who receives legal title to return the goods or land to one who has an outstanding equity unless it is unconscionable for the purchaser to retain the item, and retention is not

⁷⁴ *Winter v. Montgomery Gas Light Co.*, 89 Ala. 544, 7 So. 773 (1890) (stock certificate); *Akin v. Security Sav. & Trust Co.*, 157 Ore. 172, 68 P.2d 1047 (1937) (insurance policy); *Moore v. Holcombe*, 30 Va. (3 Leigh) 597 (1832) (non-negotiable bonds); *Williams v. Donnelly*, 54 Neb. 193, 74 N.W. 601 (1898) (tax certificates); *Mohr v. Byrne*, 135 Cal. 87, 67 P. 11 (1901) (overdue negotiable instrument); *Justice v. Stonecipher*, 267 Ill. 448, 108 N.E. 722 (1915); *Wolf v. American Trust & Sav. Bank*, 214 F. 761 (7th Cir. 1914); *YMCA Gymnasium Co. v. Rockford Nat'l Bank*, 179 Ill. 599, 54 N.E. 297, 46 L.R.A. 753 (1899). The third edition of Williston makes the following statement as to "choses in action having tangible form like certificates of stock, policies of insurance, [and] non-negotiable bonds. . . ."

The ownership of the document is regarded as conferring legal ownership of the chose in action represented by it. Accordingly a bona fide purchaser of a certificate of stock, a non-negotiable bond or note, or a policy of insurance is preferred to one having an equitable right against the assignor.

3 S. WILLISTON, *CONTRACTS* § 438, at 261-63 (Jaeger 2d ed. 1960). See also 4 A. SCOTT, *LAW OF TRUSTS* 2349 (3d ed. 1967), where the matter is put thus:

Even in states in which assignees of other choses in action take subject to latent equities, it is held that the purchaser of a chose in action represented by a specialty, even though it is not negotiable takes free of the trust upon which it is held, although the sale is in breach of trust, and free of other equitable claims of third persons, if he gives value and has no notice of the equity. It has been so held in the case of certificates of stock, nonnegotiable bonds or notes, policies of insurance and the like. [footnote omitted]

⁷⁵ *Livingston v. Dean*, 2 Johns. Ch. 479 (N.Y. 1817).

unconscionable where the transferee has given value and received possession in good faith and without notice.⁷⁶ Ames' ground is, of course, broader than Chancellor Kent's ground and would protect the assignee whether or not he could make inquiries of the third party.

The draftsmen of the first Restatement of Contracts justified the Restatement rule protecting good faith purchases of choses in action against third-party claims by noting that there is a growing tendency in the law to deal with transfers of contractual rights according to the same rules as transfers of other kinds of property. Since a person who innocently purchases land or goods from a trustee violating his trust or from a person who obtained the property fraudulently is preferred over the *cestui que trust* or defrauded party, the law should similarly prefer an innocent purchaser of a contractual right over one who has previously been deprived of the right by fraud and over one for whom the assignor held the right in trust.⁷⁷

There are policy reasons arising out of current business practice for distinguishing between the rights of the obligor and the rights of third parties as against subsequent assignees.⁷⁸ It is nearly impossible to live in modern society without making contractual promises: everyone does it. People make contractual promises on the assumption that the return performance has been, or will be, rendered. If the return performance is not rendered or is defective, the promisor can refuse to render his own promised performance. The whole law of negotiability and of cutting off claims deals with whether the promisor can refuse to perform as against assignees. The common law view that a promisor's defenses against the promisee can be asserted against transferees unless the promisor made the promise through a negotiable instrument or specifically contracted that the promisor would not assert defenses against assignees was and is based on good reasons of policy. Unless the parties expressly so agreed, the law should not require contracting parties to perform their own promises unless they receive the agreed exchange. That rule should not be subject to change through the mere expedient of an assignment. The purpose of the rules with respect to an obligor's ability to assert defenses against an assignee is to protect the obligor against being put in a substantially worse position by an assignment to which he has not consented. In any case, the assignment obligates the obligor to a person with whom he has never consented to deal; he must bear whatever disadvantage that involves because of the public advantage derived from assignability, but he should not bear any additional disadvantages.⁷⁹

⁷⁶ Ames, *supra* note 69, at 3.

⁷⁷ RESTATEMENT (FIRST) OF CONTRACTS § 174 explanatory notes (1932); see also 4 A. SCOTT, *supra* note 73, at 2348 n.6.

⁷⁸ 4 A. CORBIN, CONTRACTS § 900, at 1951 (Supp. 1971).

⁷⁹ *Id.* § 892, at 586. The sentence in the text is a paraphrase of Corbin.

The situation is different as to holders of contract rights who transfer them to others. While contracting is essential for all members of society, assignment of claims is not. Assignment of claims is a peculiarly commercial activity.⁸⁰ In today's economy there is no reason why contract rights should be less transferable than goods; and no reason why a purchaser of contract rights should get less rights than a purchaser of goods. The ability to secure immediate cash for future rights under a contract by sale of those rights is of obvious value to American business and such rights are obvious items of commerce in which there is a lively market. A person who sells contract rights certainly recognizes their commercial nature. A person who sells a contract right, induced by the fraud of the purchaser, should be able to recover the right from the purchaser upon discovery of the fraud. But, if the purchaser has, in the meantime, further transferred the right to a good faith purchaser for value without notice, the good faith purchaser should take free of claims and defenses, just as he would have taken free of a claim to a bulldozer or an automobile.

Non-negotiable checks under NUPC will with some frequency be transferred outside the banking system. Such transfers are at least as much in ordinary course of business as is a sale of goods. Further, many, if not most, transferors of non-negotiable checks will be businesses, not consumers. Whatever sympathy we may have for the consumer-drawer of a check who is defrauded into issuing the check, that should not translate into a rule protecting a merchant-transferor of such a check against a subsequent good faith assignee for value who took the check under proper endorsements.

⁸⁰ Gilmore observes that since World War II, contract rights, including longer term rights, have been the subject of commercial assignment. 1 G. GILMORE, *PERSONAL PROPERTY SECURITY* 207 (1965). However, as Professor Glenn suggested in 1934, for a long time, assignments of contract rights have been common. Glenn, *The Assignment of Choses in Action; Rights of Bona Fide Purchaser*, 20 VA. L. REV. 621, 622 (1934).

Interestingly, Gilmore, surely incorrectly, suggested that assignment of non-negotiable instruments was a noncommercial activity in the following passage in an article written in the early 1950s.

The purchaser of nonnegotiable paper not only receives almost none of the protection accorded to the purchaser of negotiable paper, he receives less protection than does the purchaser of chattels. Here the original rules of property law have stood almost unchanged: equities of ownership are effectively maintained, defenses are sedulously preserved. We have a development in three states: the purchaser of negotiable paper receives an extraordinary degree of protection; the purchaser of chattels gets less, without by any means being left naked to the elements; the purchaser of a nonnegotiable chose gets almost nothing. Why should not the development of the law of assignment have at least run even with the law of sales? The explanation lies in this inarticulate major premise: Negotiable paper is commercial property; nonnegotiable paper is noncommercial; goods can be either.

Gilmore, *supra* note 54, at 1068; see also *supra* note 73.

Perhaps consumer holders of non-negotiable checks who are induced by fraud to transfer the checks should be able to recover them from subsequent good faith purchasers for value. In this case, however, as in the case of the same issue as to entrusting, no special rule should be adopted for consumer-holders. In the first place, the subsequent good faith transferee also may be a consumer. In a dispute between two innocent consumers there is no reason to favor a different party than would be favored if the two innocent persons were nonconsumers. Second, currently under NUPC, a person is a consumer for the purposes of NUPC if he has a consumer checking account. The designation applies only as to checks the person draws on that account.⁸¹ Designating payees or holders of checks as consumers would require additional definitions and, more importantly, would introduce additional uncertainties into the check transfer system. Under the Uniform Commercial Code, the voidable title rules, under which a person who is fraudulently induced to transfer title to goods cannot recover them from a subsequent good faith purchaser, apply to consumers as well as merchants. Cutting off a consumer's claim to a check makes as much sense as cutting off his claim to a motor boat. Good faith purchasers for value of non-negotiable checks should take free of prior claims of third parties whether or not the third parties are consumers.⁸²

VI. THEFT OF NON-NEGOTIABLE CHECKS

A wrongdoer may obtain possession of a non-negotiable check through entrusting by the owner, through fraudulently inducing the owner to transfer it, or by theft. The Restatements of Contracts, Restitution, and Trusts state the rule that a person who fraudulently procures a transfer of a chose in action to him can transfer good title to the chose to a subsequent good faith purchaser for value. Those rules apply even to choses in action not represented by any paper. Presumably, however, a chose in action not represented by an essential piece of paper cannot be stolen, so that the issue of rights of takers under a thief cannot arise. On the other hand, a non-negotiable chose in action represented by a piece of paper which gives the holder thereof a right to collect on the chose clearly is subject to theft. Under Article 3 of the U.C.C., a thief of a non-negotiable check endorsed in blank could collect the check and deprive the true owner of the funds represented by the check.⁸³ The

⁸¹ See *supra* text accompanying notes 9-19.

⁸² Under NUPC, consumers frequently will be holders of negotiable checks, at least if the practice of issuing negotiable business checks continues. As NUPC is presently drafted, the ordinary rules of negotiability apply to consumer-holders of negotiable checks. Therefore, under ordinary negotiability rules, transferees with due course rights would take free of fraud or rescission claims. See NUPC 104.

⁸³ The result stated in the text is clearly applicable to checks which are non-negotiable only because they are payable to order or to bearer. See U.C.C. § 3-805. Under § 3-603 the

"3-4-8" Committee probably intends the same rules to continue under NUPC and those rules apparently apply to checks which otherwise comply with the requirements of NUPC but are not negotiable.⁸⁴

The issue which then arises is this: Payee receives a non-negotiable check, Payee endorses the check in blank, and the check is then stolen. Thief passes the check on to a subsequent good faith purchaser for value. Does the purchaser take free of Payee's interest? Assume that Dr. X receives 100 consumer checks on which she is payee. She endorses the checks in blank intending to deposit them but leaves them on her desk overnight. Thief steals the checks and deposits them in his account and subsequently withdraws the funds. Under present law, the depository bank is not likely to have any liability since the bank can be a holder in due course if it allows the thief-depositor to withdraw the funds.⁸⁵ Under NUPC, however, since the bank cannot be a holder in due course, it probably is liable in conversion for dealing with the checks on behalf of one not the true owner.⁸⁶

Consumer checks which are endorsed-in-blank and then stolen from the holder occasionally will be transferred by the thief to someone other than a bank. Suppose that Consumer draws a \$10,000 check to Payee as down-payment in a real estate transaction. Payee endorses the check in blank and leaves it in his desk. X steals the check and transfers the check to Y in payment of the price of a new automobile. Since Y cannot under NUPC have due course rights, Y on traditional theory is liable to Payee in conversion.⁸⁷

The American law of good faith purchase has not protected good faith purchasers from thieves except in the case of theft of a properly endorsed or bearer negotiable instrument. This writer is generally in

obligation of the drawer (and of the drawer's bank) is discharged when the bank pays a holder. A thief is a holder for purposes of § 3-603. Subsection three says that a party is not discharged by bad faith payment to a thief. Good faith payment to such a holder would discharge the obligation. Therefore, under the present Code, a person who endorses a check which is otherwise within Article 3 but is not payable to order or bearer can lose to a thief the value represented by the check. He may, of course, recover from the thief.

Even though the check is not payable to order or to bearer, the endorsement rules of Article 3 still apply. Therefore, the thief could not be a holder unless the check was endorsed in blank when the thief stole it. U.C.C. §§ 3-805, 1-201(2).

⁸⁴ NUPC continues the formal requisite rules of present U.C.C. which provide that an instrument is not covered by NUPC unless the instrument is an unconditional order to pay a sum certain in money on demand or at a definite time. See U.C.C. § 3-104; NUPC 10. NUPC applies to orders as defined in subsection 10, whether or not they are negotiable. The comments to NUPC 153, the counterpart of U.C.C. § 3-603, state that since NUPC applies only to authorized orders, NUPC need not deal with theft in that section. An authorized order under NUPC must be properly endorsed. See NUPC 54(1)(c). Thus, a properly endorsed order which is stolen is an authorized order. The reference to holders who acquire by theft, therefore, is just as relevant under NUPC as it is under U.C.C. § 3-603.

⁸⁵ See *supra* note 26.

⁸⁶ See *supra* note 51.

⁸⁷ *Id.*

agreement with the rule that a bona fide purchaser of goods under a thief does not take free of the true owner's interest. Perhaps the law should treat the non-negotiable check in precisely the same way as goods and impose the same conversion liability for unauthorized interference with ownership rights. However, since the owner easily can provide at least some protection to subsequent parties by not endorsing checks in blank (or by converting blank endorsements to special endorsements), the holder who fails to provide the protection should suffer the loss as he would in the case of a negotiable check.⁸⁸ Of course, not endorsing in blank provides only partial protection since a transferee may not be able to distinguish between a genuine endorsement and a forgery. A thief who steals a check already endorsed, however, may be much freer in attempting to pass the check than if he must also forge a signature. Further, occasionally the transferee actually may know the endorser's handwriting and rely on the fact that the signature is genuine. Therefore, if the holder of a non-negotiable check endorses the check in blank, or fails to convert a blank endorsement into a special or restrictive endorsement, and a thief steals the check, a subsequent good faith purchaser for value of the check should take free of the true owner's rights.

VII. SHOULD NON-NEGOTIABLE CHECKS NOT ONLY BE NON-NEGOTIABLE BUT ALSO NONTRANSFERABLE?

An argument might be made that subjecting subsequent good faith purchasers of non-negotiable checks to all claims and defenses of prior parties is merely a somewhat round about way of limiting transferability of such checks, and that limitation of transferability is a desirable change in the law.⁸⁹ In some countries, the negotiable instruments law provides for a kind of check which is nontransferable (it can be deposited only in the payee's bank account for collection).⁹⁰ However, no country

⁸⁸ See *supra* note 45.

⁸⁹ One commentator argues for an instrument which requires a bank to pay the payee, but which cannot be negotiated to a holder in due course nor assigned to anyone for the purpose of collection except a bank in which the payee has an existing account. Murray, *Crossed Checks, Account Payee, and Non-Negotiable Checks: Some Suggestions From Foreign Law*, 20 HASTINGS L. J. 273, 276 (1968). Murray points out that prohibiting transfer of checks except by direct deposit for collection could avoid much fraud and wrongdoing. *Id.* at 277.

⁹⁰ *Id.* at 287 n.69. Murray quotes Italian Royal Decree of Dec. 21, 1933, which reads: The check issued with the clause "non-transferable" may not be paid except to the payee or, on his demand, by crediting it to his account. The latter [*i.e.*, the payee] may not indorse the check unless to a banker for collection who may not further indorse it. Indorsements made in spite of this prohibition shall be considered as not being written. The cancellation of this clause is considered as non-existent.

He that pays a non-transferable check to a person different from the payee or from a banker indorsing it for collection shall be liable for the payment. Murray, *supra* note 88, at 290. Peru has a similar statute.

requires that checks drawn by a whole class of drawers, such as consumers, be so restricted as to transferability.⁹¹

Would a statute prohibiting transferability of consumer checks be a good idea? It can be said with some confidence that prohibiting transferability of consumer checks would not interfere with the vast majority of such checks since nearly all consumer checks are deposited by the payee directly in a bank account. Such a rule would, however, cause severe problems in a small but significant number of cases. There are still people who do not have bank accounts and who cash their checks, both those checks drawn by businesses and those drawn by consumers at check-cashing services or other nonbank premises. Further, check holders inconvenienced by a nontransferability rule nearly always would be consumers, and, more likely than not, less affluent consumers. Balanced against the great inconvenience which nontransferability would cause some payees, what is gained by nontransferability? The gain surely can relate only to the reduction of the kinds of losses which this article has discussed. While such losses are a matter of some concern, the losses probably are not sufficient in size to make it a wise legislative policy to prohibit transferability as to all checks, or as to certain kinds of checks. Further, if the law makes some checks nontransferable, consumer checks are probably not the best candidates since consumer checks frequently may be issued in noncommercial situations in which the payee does expect to get cash from someone other than a bank. Further, making checks nontransferable runs counter to the recent development in the law toward greater transferability of claims.⁹²

VIII. CONCLUSION

Allowing a consumer-drawer of a check to assert defenses against subsequent good faith purchasers is probably a good idea. Such a rule treats the consumer check in the same way as the law treats consumer installment notes and promises to pay not represented by an instrument. Once a consumer check is actually paid, however, the recipient of the funds should be allowed to retain them. It is unreasonably unsettling to commercial life to allow consumers who have paid by check to recover payment from good faith transferees of their checks at any time within

⁹¹ The use of the nontransferable check is not mandatory in either Italy or Peru. Murray, *supra* note 88, at 287, 290.

⁹² See 4 A. CORBIN, *supra* note 69, at §§ 872, 873; U.C.C. § 9-318 comment 4 (1981). Conceivably, however, a provision under which drawers could at their option issue nontransferable checks would be desirable.

U.C.C. § 3-206(1) makes ineffective any attempt by endorsement to prevent further transfer of an instrument. While Article 3 does not specifically so state, presumably a check marked by the drawer "nontransferable" would not be negotiable since transferability is essential to negotiability. A check marked "nontransferable" would not, therefore, be covered by Article 3 of the Code. See U.C.C. § 3-304.

the relevant statute of limitations. A rule denying recovery of payments actually made, even though the holder could not have compelled payment initially, is in accordance with a great deal of current case law.

Even though the law should permit consumer drawers to assert defenses until the check is paid, subsequent good faith transferees of checks, whether negotiable or not, should take free of the claim of any holder of the check who endorsed the check in blank. If the check was already bearer paper, and a holder failed to endorse it specially or restrictively, subsequent good faith transferees of the check should take free of the holder's claims. These rules also are consistent with much case law and with the Restatement rules as to rights of transferees of choses in action. Under NUPC such a result can be achieved either by providing that even though checks are non-negotiable, the results stated follow; or by providing that consumer checks are negotiable, but that consumer-drawer defenses are available against persons with due course rights until the check is finally paid. The law should not make consumer checks nontransferable.