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Arkansas's Revised Article 3: User Caution Advised

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ARKANSAS'S REVISED ARTICLE 3: USER CAUTION ADVISED!!

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INTRODUCTION

The reporters for the Article 3 drafting process were authorized to prepare a redraft that would modernize the substance of the Article and conform its style to that of the other articles.[1] The resulting revision of Article 3 is a major overhaul of former law. The revised Article provides welcomed clarification of some murky issues such as restitution for mistaken payment;[2] abrogates established rules such as discharge of an accommodation party upon release of the accommodated party and the doctrine of reservation of rights against a surety;[3] adds new rules and principles[4]; and changes others.[5] While some of the rules have not changed, the underlying rationale for an unaltered rule may have been modified.[6] The careful practitioner should *not* make assumptions on any issue, even those etched in stone prior to 1991. Below are some of the significant changes that may prove to be traps for the unwary or untutored.

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1. *Uniform Commercial Code Current Payment Methods Project,* 1988 A.L.I. PROGRESS REPORT 4; *see also* D. Fenton Adams, *Problems With the 1990 Revision of Articles 3 and 4 of the Uniform Commercial Code,* 15 U. ARK. LITTLE ROCK L.J. 665 (1993).

2. ARK. CODE ANN. § 4-3-418 (Michie 1991); *id.* § 4-3-418 (Michie 1987) (repealed 1991).

3. U.C.C. § 3-605, cmt. 3 (1990). *But see* Permanent Editorial Board [hereinafter PEB] Commentary No. 11, Final Draft, amendment to Comment 3, § 3-605 (Feb. 10, 1994).

4. *See, e.g.,* ARK. CODE ANN. § 4-3-411 (Michie 1991) (addressing refusal to pay cashier's checks, teller's checks, and certified checks).

5. *See, e.g.,* ARK. CODE ANN. §§ 4-3-310(4) (Michie 1991) (providing that the owner of a lost, stolen, or destroyed instrument may not recover on the underlying obligation), 4-3-402(b)(2) (Michie 1991) (providing that a representative may not be liable to a remote holder who is not a holder in due course).

6. *See, e.g.,* ARK. CODE ANN. § 4-3-305(3) (Michie 1991) (distinguishing claim in recoupment from a defense).

I. Good Faith

Because former Article 3 did not contain a definition of good faith, the subjective test of good faith, honesty in fact, of Article 1[7] was applicable under the former Article. Revised Article 3 now contains its own definition of good faith which entails both a subjective and an objective test.[8] Under revised Article 3, good faith means honesty in fact and the observance of reasonable commercial standards of fair dealing.[9] Eleven sections of revised Article 3 and ten sections of amended Article 4[10] require the application of the two-part test of good faith. The subjective standard "requires the trier of fact to focus on the . . . [party's] state of mind."[11] But, what does "fair dealing" entail, especially in determining holder in due course status?

The objective component of the test, fair dealing, is not a negligence test,[12] but is equivalent to the second prong of the merchant test of good faith under Article 2. In a given transaction, the practitioner must ask whether the conduct complained of is consistent with the reasonable expectations of the parties in light of their prior course of dealings, if any; their course of performance, if any; the prevalent practices regularly observed by those who engage in the applicable business, profession, or capacity; and the express terms of the instrument, even if the conduct is negligently but honestly done.[13] The commercial context in which the conduct occurs determines if the conduct is decent or fair.[14]

Comment 4 to revised Section 3-311 provides insight into the concept of fair dealing. Comment 4 states that an insurance company may lack good faith if it tenders a check in an unreasonably small amount as an offer of an accord for a covered personal injury knowing

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7. U.C.C. § 1-201(19) (1989).

8. Ark. Code Ann. § 4-3-103(a)(4) (Michie 1991).

9. *Id.*

10. Amended Article 4 incorporates in its definitional terms revised Article 3's definition of good faith. Ark. Code Ann. § 4-4-104(c) (Michie 1991).

11. Susan A. Wegner, Comment, *Section 1-208: "Good Faith" and the Need for a Uniform Standard*, 73 Marq. L. Rev. 639, 650 (1990).

12. U.C.C. § 3-103(a)(4), cmt. 4 (1990).

13. *See generally* Proposed Final Draft of PEB Commentary No. 10, § 1-203 (Feb. 10, 1994); Nanakuli Paving & Rock Co. v. Shell Oil Co., 664 F.2d 772, 32 U.C.C. Rep. Serv. 1025 (9th Cir. 1981) (holding seller breached its duty to post price in good faith when it failed to give either advance notice of pending price change or to price protect for forward contracts entered by buyer before the posting as practiced by the relevant trade).

14. *See generally* E. Allen Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. Chi. L. Rev. 666, 669 (1963).

that the insured desperately needs the money. Although this conduct could pass the "honesty in fact" test, it does not reflect fair dealing. Thus, to obtain holder in due course status, the holder must take the instrument honestly while dealing fairly. The new definition is unlikely to change the result in *Rose v. Spear*,[15] a case involving unusual circumstances.

In *Rose*, the owner of bearer bonds lost possession of them because of a fraudulent scheme. Later, the holder took the bonds at a gambling house, at night, from two strangers, to secure a loan for one-fourth of the value of the bonds. The bonds were not overdue. The Arkansas Supreme Court held that a careful examination of the facts did not reveal actual knowledge or knowledge of such facts that amounted to taking the bonds in bad faith. As other courts have done, the Arkansas Supreme Court recognized that the failure to acquire knowledge in some circumstances is the equivalent of bad faith or dishonesty.[16] However, bad faith was not established here. More importantly, the facts would not establish unfairness in dealing between the holder and the transferors under the revised Article. There were no prior dealings between the transferors and the holder to establish any standard of conduct that could be violated; holder was not a broker or dealer in bonds and could not, therefore, be held to any custom for valuing or handling the bonds; because the bonds were taken as "security for" rather than "in payment of" the loan, no overreaching occurred in the exchange of values in the transactions;[17] and the facts do not suggest oppression in the bargaining process.[18] Thus, the good faith test under the revised Article would be satisfied.

II. SURETYSHIP

A. The Accommodated Party

Under former Article 3, Section 4-3-415, "accommodated party" was not a defined term, but, by implication, the accommodated party was that party to the instrument to whom the accommodation party (surety) was "lending his name."[19] Revised Article 3 supplies a definition

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15. 187 Ark. 168, 58 S.W.2d 684 (1933).

16. *See, e.g.*, Scott v. Davis, 214 Ark. 19, 24, 214 S.W.2d 504, 506 (1948).

17. *See* Henry J. Bailey, *New 1990 Uniform Commercial Code: Article 3, Negotiable Instruments, and Article 4, Bank Deposits and Collection*, 29 WILLAMETTE L. REV. 409, 424 (1993) (suggesting fair dealing test might trigger the concept of unconscionability).

18. *Id.*; *see also*, U.C.C. § 2-302 (1989).

19. ARK. CODE ANN. § 4-3-415(1) (Michie 1987) (Repealed 1991).

for accommodated party and thereby limits the scope of "accommodated party" as previously recognized. Only a party who is a party to the instrument at the time of issuance and for whose benefit value is given at the time of issuance can attain the status of "accommodated party."[20]

Consequently, if a party whose engagement is being enhanced by the presence of a surety or secondary obligation (the principal debtor/obligor) was either not a party when the instrument was issued or was a party at issuance *but* the instrument was issued for another's benefit, then general suretyship law will govern the rights between the principal debtor/obligor on the instrument and its surety (secondary obligor) who is also a party to the instrument. However, revised Article 3 will govern the rights and duties between any other party to the instrument who was a party at the time of issuance and received a direct benefit (accommodated party) and the surety (accommodation party). For example,

> Corporation A issues a note payable to Partnership that takes for value. Partnership seeks to discount the note to Finance Company. Finance Company is willing to purchase the instrument if Partner X indorses the instrument personally. If Partner X indorses the instrument without receiving a direct benefit, Partner X is an accommodation party. As a party at the time the note was issued and having received a direct benefit of the value given at issuance, Corporation A is an accommodated party. Although Partnership is a party (the payee) to the instrument at issuance, value is not given for Partnership's benefit at issuance. Partnership is not an accommodated party under Article 3 but a principal debtor/obligor under general suretyship law.

General suretyship law will govern the rights and obligations between Partner X, Partnership, and Finance Company while revised Article 3 will govern the rights and obligations between Partner X, Corporation A, and Finance Company. Conduct by Finance Company may, in some cases, result in varying outcomes under the two different sets of rules. Areas of difference between general suretyship law and revised Article 3 include the rights of reimbursement, enforcement, subrogation, and the obligation of a creditor (obligee) to preserve the secondary obligor's right of recourse.[21]

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20. PEB Commentary No. 11, Final Draft, Issue 1, Discussion at 2 (Feb. 10, 1994); U.C.C. §§ 3-419(a), 3-105(a) (1990).

21. *Compare* ARK. CODE ANN. § 4-3-419(e) (Michie 1991) with RESTATEMENT OF SURETYSHIP §§ 18, 19, 22 (Tentative Draft No. 2, 1993). *See generally* Sarah H. Jenkins, *Revised Article 3: Suretyship and Accord & Satisfaction*, printed in ALI-ABA Course of Study Materials, *The Emerged and Emerging New Uniform Commercial Code* (December 1993).

B. The Accommodation Party

Revised Article 3 defines an accommodation party as one who signs the instrument to incur liability on the instrument without being a direct beneficiary of the value given.[22] Comment 1 to the promulgated version distinguishes between direct and indirect benefit. Thus, an officer or shareholder who signs an instrument to incur liability and only receives an indirect benefit should be deemed an accommodation party. This clarification is consistent with the holdings in *Hanson v. Cheek*[23] and *Riegler v. Riegler*,[24] but should change the outcome of the determination under former law of accommodation party status in *Nelson v. Cotham*.[25] In *Nelson v. Cotham*, a shareholder did not attain accommodation status because signing the corporation's note benefitted his business interest when the corporation received funds to keep the corporation "afloat."

Under the revision, neither an officer nor a shareholder should fail to attain accommodation party status for the receipt of an indirect benefit. For example, if the value received in exchange for a negotiable instrument is placed in the entity's account and is used as working capital by the entity and an officer receives a salary in the ordinary course of business or consistent with contract terms, express or implied, the officer should attain the status of accommodation party. Likewise,

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22. ARK. CODE ANN. § 4-3-419(a) (Michie 1991). In Mobley v. Harmon, 304 Ark. 500, 803 S.W.2d 900 (1991), the Arkansas Supreme Court applied the direct benefit test and correctly determined that the cosigner was in fact the accommodated party. However, the court's construction of former section 4-3-606(1)(a) as permitting an accommodated party to be entitled to a discharge because of an extension granted to the accommodation party misses the mark. Former 4-3-606 and revised 4-3-605 only recognize a suretyship defense for one with a right of recourse. An accommodated party has no right of recourse against the accommodation party. ARK. CODE ANN. § 4-3-419(e) (Michie 1991); *id.* § 4-3-415(5) (Michie 1987). The following reading of former 4-3-606(1)(a) is the proper reading:

> The holder discharges any party to the instrument to the extent that without such party's consent the holder: (a)Without express reservation of rights releases or agrees not to sue *any person against whom the party has to the knowledge of the holder a right of recourse* or agrees to suspend the right to enforce against *such person* [any person against whom the party has to the knowledge of the holder a right of recourse] the instrument or collateral or otherwise discharges *such person* [any person against whom the party has to the knowledge of the holder a right of recourse] . . . .

ARK. CODE ANN. § 4-3-606(1)(a) (Michie 1987) (repealed 1991) (emphasis added). Thus, the accommodated comaker was not entitled to a discharge.

23. 251 Ark. 897, 475 S.W.2d 526 (1972).

24. 244 Ark. 483, 426 S.W.2d 789 (1968).

25. 268 Ark. 622, 595 S.W.2d 693 (Ark. Ct. App. 1980) (signing of note by shareholder was to benefit his business interests by obtaining funds to keep his corporation going).

if a shareholder receives dividends as declared by the board of directors, in the absence of facts establishing that the sole purpose of obtaining the value given was to provide funds for the shareholder, the indirect benefit should not prevent the shareholder from attaining accommodation party status. In a fact pattern similar to *Nelson*, some other rule or principle of law or equity may limit the shareholder's right to enforce the instrument or assert its right of restitution under revised Section 4-3-419(e), but the shareholder's status as an accommodation party must be determined on the basis of whether a direct benefit was received as the new section requires.

C. The Effect of Releases, Extensions, and Modifications on the Accommodation Party

1. *Reservation of Rights*

Under former Article 3, to prevent the discharge of an accommodation party and to preserve the accommodation party's right of recourse against the accommodated party, a holder could simply reserve its rights when granting the accommodated party a release or an extension in time for payment.[26] However, revised Article 3 abolishes the reservation of rights doctrine.[27] Under the terms of revised Section 4-3-605, the holder's rights against the accommodation party are *not* adversely affected unless, in some cases, the accommodation party suffers loss.[28]

2. *Extensions in Time[29] and Material Modifications*

A much litigated issue under former Arkansas law was the effect of an extension in time or a material change in the underlying

26. ARK. CODE ANN. § 4-3-606(2) (Michie 1987).

27. U.C.C. § 3-605, cmt. 3 (1990). The PEB Commentary proposes an amendment to comment 3. The amendment rephrases the language of Comment 3 to eliminate the *necessity* of reserving rights, rather than abolishing the doctrine of reservation of rights as Comment 3 currently states, to preserve recourse against the accommodation party.

28. General suretyship law is distinguishable from the new rule of revised Article 3. A secondary obligor (surety) is discharged by the obligee's agreement to release or extend the time of the principal obligor's performance unless the *express terms* of the release or extension provide that the obligee's (creditor's) rights against the secondary obligor and the secondary obligor's rights against the principal obligor are retained. RESTATEMENT OF SURETYSHIP § 34 (Tent. Draft No. 2, 1993). Upon express preservation of rights, the secondary obligor's rights against the principal obligor are retained as though the release or extension did not occur. *Id.* § 34(2).

29. For a discussion of the effect of an extension of the due date on the accommodation party's duty to perform, see Sarah H. Jenkins, *Revised Article 3: Suretyship and Accord & Satisfaction*, printed in ALI-ABA Course of Study Materials, *The Emerged and Emerging New Uniform Commercial Code* (December 1993).

obligation on the accommodation party's duty to perform.[30] Under former law, in the absence of consent or reservation of rights, the accommodation party was discharged upon any suspension of the right of enforcement or material alteration of the accommodated party's duties. If the accommodation party consented in advance to renewal of the obligation or change in interest rate, in the absence of language indicating that successive extensions (renewals) or changes 9were authorized, Section 4-3-118(f) limited the prior consent to a single extension not longer than the original term of the obligation.

Revised Article 3 substantially modifies these rules. First, an accommodation party is only discharged upon an extension in time, with or without consideration, if the accommodation party[31] proves that the extension caused loss with respect to its right of recourse.[32] On the other hand, if a material modification other than an extension in time occurs, such as an increase in interest rate, the accommodation party is discharged to the extent of its right of recourse *unless* the person enforcing the obligation proves that no loss resulted or the amount of loss was less than the amount of the right of recourse.[33]

Furthermore, revised Section 4-3-605(i) expressly authorizes consent to conduct that could otherwise result in discharge. More significantly, the text of former Section 4-3-118(f) is deleted from the revised statute. The statutory authorization to limit the effectiveness of prior consent to an extension in time to one single extension no longer exists. Thus, the accommodated party's consent should not be limited to one single extension or a single change in rate in the absence of an express term to the contrary. This is a significant change from the case law that developed under former Article 3.[34]

D. Release or Discharge of the Accommodated Party

Discharge or release of the accommodated party by the holder without the consent of the accommodation party or reservation of rights against the accommodation party discharged the accommodation party under former law.[35] Revised Section 4-3-605(b) changes this

30. Sanders v. Stephens Sec. Bank, 75 B.R. 746 (W.D. Ark. 1987); Sanders v. First Nat'l Bank, 75 B.R. 751 (W.D. Ark. 1987); Sanders v. Merchants & Planters Bank, 75 B.R. 757 (W.D. Ark. 1987); McIlroy Bank & Trust v. Maestri, 297 Ark. 130, 759 S.W.2d 808 (1988).

31. By its terms, § 4-3-605 is also applicable to indorsers. ARK. CODE ANN. § 4-3-605 (Michie 1991).

32. ARK. CODE ANN. § 4-3-605 (Michie 1991).

33. ARK. CODE ANN. § 4-3-605(d) (Michie 1991).

34. *See supra* note 30.

35. ARK. CODE ANN. § 4-3-606(1)(a) (Michie 1987) (Repealed 1991).

result. Release of the accommodated party does not discharge the accommodation party. Furthermore, unlike the effect of loss on the accommodation party's duty of performance if an extension in time is given or a material modification occurs, sustaining a loss upon the release of the accommodated party does not minimize the accommodation party's liability.[36]

III. Indorser's Duty to Pay Subsequent Indorsers

A. Anomalous Indorsers

Under prior Article 3, in the absence of agreement, the relationship between anomalous successive indorsers[37] or sureties was that of subsuretyship. Each subsequent indorser had a right of indemnification from the prior indorser.[38] Revised Article 3, however, changes the presumption. Except as provided in the instrument or by agreement of the affected parties, two or more persons who have the same liability on an instrument as anomalous indorsers are jointly and severally liable with a right of contribution.[39] Thus, a cosuretyship relationship is presumed. The kind of contract engagement made rather than the "successive" nature of indorsements determines the nature of the relationship between anomalous indorsers.

B. Other Indorsers

Indorsers who are not anomalous indorsers, indorsers outside the chain of title, or sureties, owe an obligation of performance to any subsequent indorser. Thus, under revised Article 3 a subsequent indorser may enforce the obligation of any prior indorser.[40]

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36. Ark. Code Ann. § 4-3-605(b) (Michie 1991). The formulation and effect of U.C.C. § 3-605 has been criticized. *See generally* Neil B. Cohen, *Suretyship Principles in the New Article 3: Clarifications and Substantive Changes*, 42 Ala. L. Rev. 595 (1991); Sarah H. Jenkins, *Abrogation of the Surety's Right of Discharge on Release of the Principal Obligor Under Revised Article 3: A Creditor's Tool for Maximizing Self-Interest*, 44 Okla. Law Rev. 661 (1992); *see also* Donald J. Rapson, *History and Background of the Restatement of Suretyship*, 34 Wm. & Mary L. Rev. 989, 1005 n.74 (1993).

37. Anomalous indorsers are indorsers outside the chain of title and are presumed to be sureties under both the former and revised articles. Ark. Code Ann. § 4-3-415(3) (Michie 1987); Ark. Code Ann. § 4-3-205(d) (Michie 1991).

38. Ark. Code Ann. § 4-3-414(2) (Michie 1987).

39. Ark. Code Ann. §§ 4-3-205(d), 4-3-116(a), (b) (Michie 1991).

40. Ark. Code Ann. § 4-3-415(a) (Michie 1991).

IV. Effect of Words of Guaranty on Indorser's Obligation

Words guaranteeing payment added to an indorsement under former Article 3 waived presentment, notice of dishonor, and protest.[41] However, the Permanent Editorial Board has expressed an intent to clarify this rule under revised Article 3.[42] Under the proposed clarification stated in PEB Commentary Number 11, unless the added words unambiguously guarantee collection, words of guaranty will be without effect. The engagement will be treated as an engagement without words of guaranty and presentment and notice of dishonor would be required. Language guaranteeing payment no longer results in an engagement to pay without resort to any other party. Consequently, language guaranteeing payment does not waive presentment, notice of dishonor, and protest.[43] Under this revision to comment 4 to revised Section 3-419, the express repeal of prior law under Section 3-416 (1), (3), and (5) is clarified.

V. Accord and Satisfaction

A. Discharge of an Unliquidated or Disputed Claim

The common law doctrine of accord and satisfaction recognized the discharge of an unliquidated or disputed claim upon the creditor's negotiation of a check containing an explicit declaration that it was tendered in full and final settlement of claims. The precept also applied where the debtor tendered a check accompanied with an oral declaration of similar content. A creditor could not avoid the effect of the doctrine by cancelling the explicit declaration or otherwise reserving rights or protesting before negotiating the instrument.

By its terms, former Section 1-207 permitted a party to act consistently with terms offered by another without prejudice to any rights held if there was explicit reservation of rights. Courts and commentators were divided on the issue of whether Section 1-207 abrogated the common law rule of accord and satisfaction.[44]

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41. Ark. Code Ann. § 4-3-416(1), (5) (Michie 1987).

42. PEB Commentary No. 11, Final Draft, revised Comment 4 to U.C.C. § 3-419 (Feb. 10, 1994).

43. *Id.*

44. *See* Anderson v. Rosebrook, 737 P.2d 417, 3 U.C.C. Rep. Serv. 2d 1312 (Colo. 1987); County Fire Door Corp. v. C.F. Wooding Co., 520 A.2d 1028, 3 U.C.C. Rep. Serv. 2d 1 (Conn. 1987); Pillow v. Thermogas Co., 6 Ark. App. 402, 644 S.W.2d 292, 35 U.C.C. Rep. Serv. 1404 (Ark. Ct. App. 1982); Rosenthal, *Discord and Dissatisfaction: Section 1-207 of the Uniform Commercial Code*, 78 Colum. L. Rev. 48 (1978). *But see* AFC Interiors v. DiCello, 544 N.E.2d 869, 9 U.C.C. Rep. Serv. 2d 1181 (Ohio 1989); Horn Waterproofing Corp. v. Bushwick Iron & Steel Co., 488 N.E.2d 56, 41 U.C.C. Rep. Serv. 1591 (N.Y. 1985); J. White & R. Summers, Uniform Commercial Code §§ 13-21 (3d ed. 1988).

The 1991 amendment to Section 4-1-207(2)[45] expressly exempts accord and satisfaction from the application of Section 1-207. Revised Section 4-3-311 governs the effect of the tender of a negotiable instrument with an explicit declaration or accompanying communication. Revised Section 4-3-311 codifies the doctrine reflected in *Pillow v. Thermogas Co.*,[46] with limited adaptations in recognition of modern business methods of handling negotiable instruments.[47] This rule has an effect on the law concerning accommodation parties. Although the release of the accommodated party is not a defense to the accommodation party's obligation even though the accommodated party pays some consideration for the release,[48] if the accommodated party's release results from an accord and satisfaction in settling a disputed claim, the accommodated party's obligation is discharged and the accommodation party has a defense to its obligation.[49]

VI. Conversion and Forgery

A. Conversion

One area of former Article 3 in need of monumental change was that of conversion liability. Under former law, a depositary bank was not a proper defendant in a conversion action if it had with good faith, honesty in fact, and according to reasonable commercial standards of ordinary care of the industry in its locality[50] dealt with an instrument bearing a forged indorsement **unless** it had proceeds in its hands.[51] As a result, the true owner was often forced to seek recovery from a distant payor bank which in turn sued the depositary bank that dealt with the forger for its breach of presentment warranty. The former rule was inefficient and inconvenient.

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45. Ark. Code Ann. § 4-1-207 (Michie 1991); *see also* Ark. Code Ann. § 4-3-311 (Michie 1991).

46. 6 Ark. App. 402, 644 S.W.2d 292 (1982).

47. *See* Hardison v. Jackson, 45 Ark. App. 49, 871 S.W.2d 410 (1994); Burke Co. v. Hilton Dev. Co., 802 F. Supp. 434, 19 U.C.C. Rep. Serv. 2d 6 (N.D. Fla. 1992) (discussing revised § 3-311); Arthur G. Murphey, *Revised Article 3 and Amended Article 4 of the Uniform Commercial Code: Comments on the Changes They Will Make*, 46 Ark. L. Rev. 501, 532-38 (1993).

48. U.C.C. § 3-605(b) (1990); U.C.C. § 3-605, cmt. 3 (1990).

49. PEB Commentary No. 11, Final Draft, amended comment 5 to U.C.C. § 3-305 (Feb. 10, 1994).

50. Ark. Code Ann. § 4-3-419 (Michie 1987).

51. *See* First Bank & Trust v. Vaccari, 288 Ark. 233, 703 S.W.2d 867 (1986) (finding depositary bank acted commercially unreasonably in failing to inquire into depositor's authority to open and deposit checks into new account).

Revised Article 3 now authorizes direct action by the true owner[52] against the depositary bank. A depositary bank falls within the definition of a "bank [that] . . . obtains payment,"[53] and, further, the depositary bank is expressly excluded from the statutory exception to liability for conversion available for certain representatives.[54] This was a much needed change.

B. Forgery

Revised Article 3 also expands the defenses available to those subject to liability, such as a depositary bank, for making or obtaining payment of instruments bearing indorsements forged by employees. The revision allocates to employers the risk of loss for indorsements forged by certain classes of employees. The employer is in the best position to avoid and minimize loss by selecting and supervising its employees, and through implementing measures to prevent loss.[55] If an employee, including an independent contractor or its employee, who has responsibility for instruments[56] forges an indorsement of the employer or of the payee of an instrument issued by the employer, the indorsement is effective as to one who in good faith pays or takes the instrument for value or collection.[57] Furthermore, negligence or the failure to exercise ordinary care will not preclude the person taking or paying in good faith from asserting the effectiveness of the indorsement. However, if the negligence of the person taking or paying the instrument substantially contributes to loss suffered by the employer, the employer may recover to the extent the failure to exercise ordinary care contributed to the loss.[58]

Under revised Article 3, the outcome of *First Bank & Trust v. Vaccari*[59] may be altered. In *Vaccari*, a bookkeeper with check writing authority for eleven years was terminated after her embezzling was

52. Revised Article 3 also delineates the proper plaintiff in a conversion action. ARK. CODE ANN. § 4-3-420(a)(i-ii) (Michie 1991).

53. ARK. CODE ANN. § 4-3-420(a) (Michie 1991).

54. ARK. CODE ANN. § 4-3-420(c) (Michie 1991).

55. U.C.C. § 3-405, cmt. 1 (1990).

56. Responsibility is broadly defined as authority to sign or indorse; to process instruments for bookkeeping, deposit, or other disposition; to supply information regarding payee names or addresses; to control the disposition of instruments issued in the name of the employer; or to act otherwise with respect to instruments in a responsible capacity, but not including access to instruments or blank or incomplete instruments that are being stored, transported, or are part of the mail. ARK. CODE ANN. § 4-3-405(a)(3) (Michie 1991).

57. ARK. CODE ANN. § 4-3-405 (Michie 1991).

58. *Id.*

59. 288 Ark. 233, 703 S.W.2d 867 (1986).

discovered. Later, she was rehired as bookkeeper but without check writing authority. Thereafter, she opened an account in Jonesboro in the employer's name (Walnut Ridge Flying Service) using the employer's tax identification number and address. No indicia of authority such as resolutions by the Board of Directors was requested by the bank's new-accounts clerk.[60] Thereafter, the bookkeeper deposited checks payable to her employer and appropriated $41,000 in funds. The jury found the depositary bank failed to act consistent with reasonable commercial standards. Because it failed to satisfy the exemption from liability available under former Article 3, the depositary bank was liable for the amounts appropriated.

Under the new law, the depositary bank would be liable for conversion because it obtained payment of an instrument for one not entitled to enforce the instrument—the bookkeeper. However, the loss may be allocated to the employer under Section 4-3-405 because the bookkeeper is an employee.

Although she no longer had check-writing authority, if when rehired she had some authority to process instruments for bookkeeping purposes or to otherwise handle checks within the broad statutory definition of "responsibility," the employer will be allocated the loss if the depositary bank can satisfy the new good faith test. Here, the bank honestly took the instrument for collection and did not violate the mores of fair dealing, but it violated its duty of ordinary care in failing to require some indicia of authority. This kind of negligence has been held to satisfy the "substantially contributed test" in another jurisdiction.[61] Under the revised article, however, the depositary bank is entitled to have its negligence compared with the employer's and to shift much of the loss to the employer that granted a known embezzler "responsibility" for instruments. Hence, the employer should only recover to the extent the bank's lack of care contributed to the loss.

Even assuming that the employee did not have check-writing responsibility within revised Section 4-3-405(a)(3), revised Section 4-3-406 contains a similar comparative negligence standard. Ultimately, if both the bank and the employer were negligent, both must bear some responsibility for the loss.

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60. The court's opinion suggests that the depositing of corporate checks into the bookkeeper's individual account, "her account," violated reasonable commercial standards. The account was in a name substantially similar to that of the corporation.

61. *See, e.g.*, Gresham State Bank v. O & K Constr. Co., 370 P.2d 726, 1 U.C.C. Rep. Serv. 276 (Or. 1962).

VII. Signatures by Representatives

A. The Principal's Liability

Under former Article 3, a principal could potentially escape liability on a negotiable instrument signed by its authorized agent. Section 3-401 limits liability on a negotiable instrument to one whose signature appears on the instrument. Although former Section 3-403(1) provided that a signature could be made by an agent or other representative, comment 2 to the Section stated that a principal was only liable if the instrument named the principal and showed that the signature was made on behalf of the principal. Thus, if an agent had actual, apparent, or inherent power to bind the principal to a promise or order to pay and the agent only signed his or her name, the holder could not recover from the principal on the instrument. Furthermore, in litigation between immediate parties, the payee and the agent, the agent could establish that no personal liability was intended and the payee would be left without a right of recovery. This outcome was inconsistent with general agency principles[62] and was criticized.[63] The Arkansas Supreme Court refused to follow the literal requirements of the statute in litigation between immediate parties.[64] Because parol evidence was admissible to show that the payee and agent did not intend the agent to be personally liable on the instrument, the court authorized the admission of parole evidence to establish the principal's liability.[65]

Under former Article 3 parole evidence was inadmissible in litigation between remote parties, a subsequent holder and the agent.[66] Consequently, in those cases, the agent was bound and the absurd result did not follow.

Revised Article 3 changes the rule of the former article and recognizes the liability of the principal when the signature executed by an agent would bind a principal under agency law even though the principal is unnamed in the instrument and representative capacity

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62. *See* Sarah H. Jenkins, *A Payee Who is a Holder in Due Course May be Subject to Personal Defenses Arising From Unauthorized Acts or Promises by an Agent*, 9 St. Louis Pub. L. Rev. 191, 208 (1990).

63. Evelyn Hills Pharmacy, Inc. v. First Nat'l Bank, 289 Ark. 351, 712 S.W.2d 291 (1986); J. White & R. Summers, Uniform Commercial Code §§ 490-92 (2d ed. 1980).

64. Evelyn Hills Pharmacy, Inc. v. First National Bank, 289 Ark. 351, 712 S.W.2d 291 (1986).

65. *Evelyn Hills Pharmacy*, 289 Ark. at 355, 712 S.W.2d at 293.

66. Ark. Code Ann. § 4-3-403(2)(b) (Michie 1987).

is not shown.[67] An authorized agent who signs his or her name or the name of the principal without showing representative capacity binds the principal.

B. Representative Liability

Under former law, an agent was liable on the instrument if the principal's identity was undisclosed on the instrument; that is, neither the principal's name nor the agent's representative capacity was shown. As discussed above, in litigation between immediate parties, the payee and the agent, an agent who failed to either name the principal or failed to include representative capacity in his or her signature could introduce parol evidence to establish that personal liability was not intended.[68] This right was unavailable in litigation between remote parties.[69] Revised Article 3 changes the rule of representative liability. If the agent ambiguously shows representative capacity, the agent either names the principal or shows representative capacity without naming the principal, the agent is liable on the instrument to a holder in due course.[70] Hence, in litigation between a holder subsequent to the payee, the agent may introduce parol evidence to show that personal liability was not intended if the holder is not in due course. The subsequent non-HDC is subject to the personal defense of representative capacity.

CONCLUSION

Revised Article 3 provides some welcomed changes and clarifications in negotiable instrument law. However, new problems and questions must be resolved. A practitioner should carefully review all relevant sections before attempting to advise a client or provide direction to a court on the effect of revised Article 3.

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67. See Jenkins, *supra* note 62, at 202-11, for a discussion of general agency principles.

68. ARK. CODE ANN. § 4-3-403(2)(a) (Michie 1987).

69. ARK. CODE ANN. § 4-3-403(2)(b) (Michie 1987).

70. ARK. CODE ANN. § 4-3-402(b)(2) (Michie 1991).