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TWENTY YEARS AFTER: REFLECTIONS ON THE
UNIFORM COMMERCIAL CODE IN
ARKANSAS—ARTICLES 3 AND 4

Arthur G. Murphey Jr.*

INTRODUCTION

The Arkansas Legislature adopted the Uniform Commercial Code in 1961 with the passage of Act No. 185. The Act became effective January 1, 1962, and citations to the Code began to appear in the appellate cases a few years later. So the Code has been in effect for approximately twenty years. It has been amended and revised since then from time to time, the last major change occurring in 1973 when Act 116 adopted the 1972 Official Text. The changes reflected by that Text mainly affected Article 9. Changes in Article 8 are reflected in the 1978 Official Text, and it is possible that these changes will soon be adopted in Arkansas also. Work is now underway to revise Articles 3 and 4 by means of the New Uniform Payments Code. All of these changes have been the result of the continuing work to have the Code provide meaningful solutions to current problems.

This article will not summarize all the statutes enacted and the cases which have construed the Uniform Commercial Code over the past twenty years. Rather it will focus on five areas, not always with the same goal in mind. In some instances the goal is to illustrate and comment on the direction the courts have taken. In others it is to examine certain problems that have not arisen in Arkansas, but that might arise. Suggested solutions are based on the words of the sections (and comments) or on interpretations already given by the courts to sections or a combination of these. In still other instances the goal is

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3. For a discussion of some of the work on the NUPC and how it could affect certain code provisions, see Benfield, The New Payments Code and the Abolition of Holder in Due Course Status as to Consumer Checks, 40 Wash. & Lee L. Rev. 11 (1983).
simply to explain the meaning of a section of the Code. Sometimes this is best done by examining prior law to see what change the section was supposed to bring about. Sometimes it is best to work with concepts and principles.

Article 3 is entitled "Commercial Paper." It is concerned with negotiable instruments, their issue, transfer, and discharge, and the rights and duties that attach to them. Article 4 is entitled "Bank Deposits and Collections" and is concerned primarily with the collection of one type of negotiable instrument, the check. It devotes some sections to the collection of the documentary draft, and by providing for the collection of "items," it can apply to nonnegotiable instruments sent through the banking system for collection. But primarily Article 4 is called on to determine the rights and duties of parties involved in the collection of checks by banks. There is then a close relationship between the two articles and they will not be separated below.

I. FOUR WORDS AND THEIR APPLICATION

A. "Assignment"

The first area to be discussed is that of words found in the Uniform Commercial Code or used by courts in their opinions (even though the words are not so used in the Code). Let us start with a word that the courts have used but that the Code does not define. In such cases it is helpful if such a word describes a person or thing or process in a way familiar to those who work in the particular fields involved (in this case contract law and property law).

Begin with the process of transfer of an instrument. Even if an instrument is negotiable it may be transferred by a method other than negotiation. Such a transfer occurs if the holder of an instrument payable to his order fails to indorse it when he transfers it.6 The best word

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4. Ark. Stat. Ann. § 85-4-104(1)(g) (1961) provides: "Item" means any instrument for the payment of money even though it is not negotiable but does not include money.
5. Ark. Stat. Ann. § 85-3-201(1) (1961) describes the effect of a transfer in general: Transfer of an instrument vests in the transferee such rights as the transferor has therein, except that a transferee who has himself been a party to any fraud or illegality affecting the instrument or who as a prior holder had notice of a defense or claim against it cannot improve his position by taking from a later holder in due course.

§ 85-3-202(1) is concerned with a particular kind of transfer, a negotiation:
Negotiation is the transfer of an instrument in such form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with any necessary indorsement; if payable to bearer it is negotiated by delivery.

The Code does not provide a word to describe transfers that are not negotiations.
to describe this transfer is probably "assignment". In 1971 the Arkansas Supreme Court twice referred to notes as being "assigned." However, in 1972 it said that "the U.C.C. does not permit assignments of negotiable instruments...the note must be transferred or negotiated." "Negotiated" is a technical word. It is used in a sense different from that in the sentences "The nations negotiated a treaty" and "The parties negotiated but failed to reach an agreement on the contract." "Negotiated" is the proper term to describe transferring a negotiable instrument with needed indorsements. But it is submitted that "transferred" is not the only proper term for describing the transfer of a negotiable instrument without a needed indorsement. "Assigned" should be an acceptable word to describe what is done. And it might be even better than "transfer." For consider section 3-417(2) which begins, "Any person who transfers an instrument...warrants...and if the transfer is by indorsement..." Thus there can be a transfer with or

6. Byrd v. Security Bank, 250 Ark. 214, 215, 464 S.W.2d 578, 579 (1971); Griffith v. Griffith, 250 Ark. 845, 846, 467 S.W.2d 737, 738 (1971). In Byrd, the court apparently was using the word to refer to a note that had been negotiated. It also did this in two later cases, Richardson v. Girner, 282 Ark. 302, 302-04, 668 S.W.2d 523, 524-25 (1984), and Bryan v. Easton Tire Co., 262 Ark. 731, 732, 561 S.W.2d 79, 79 (1978). The Court of Appeals did the same in Parker v. Pledger, 269 Ark. 925, 927, 601 S.W.2d 897, 898 (Ark. Ct. App. 1980). In none of these did the court comment on the proper use of "assignment". In Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200, 1212 (E.D. Ark. 1972) a federal court used the word "assignee" to refer to the pledgee of a note who took it without an indorsement that was needed for negotiation.

It may be objected that the word "assignee" is proper only in the case of a negotiation since ARK. STAT. ANN. § 85-3-110 (1961) provides that an instrument is payable to order (and hence negotiable) when it is payable "to the...assigns of any person...". However, this is probably a concession to people who use the word "assigns" thinking that it means the same as "holders." Since they mean for the instrument to be negotiable, the drafters provided a way for their intention to govern. The word "assigns" has long been associated with conveyancing. It is significant that the drafters did not use the word "assignees." The heart of negotiable instrument law is that there is such a person as a holder in due course with rights superior to those of a mere assignee (of contract rights).

The case of Bryan v. Bartlett, 435 F.2d 28 (8th Cir. 1970) may be of some interest at this point. It was governed by the federal common law. There was probably no indorsement of an instrument to the receiver of the holder. Although this is not certain from the facts, it seems most likely. Yet the court held that the receiver was a "holder." 435 F.2d at 34. Compare Ark. Stat. Ann. § 85-3-110(1)(f) (1961) which lets "successors" of the holder of an office "act as if...they...were the holder."

8. ARK. STAT. ANN. § 85-3-417(2) (1961) provides:
   Any person who transfers an instrument and receives consideration warrants to his transferee and if the transfer is by indorsement to any subsequent holder who takes the instrument in good faith that
   (a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title and the transfer is otherwise rightful; and
   (b) all signatures are genuine or authorized; and
   (c) the instrument has not been materially altered; and
without an indorsement. If an instrument is payable to order, a transfer without an indorsement is not a negotiation. If an instrument is payable to the order of the indorser a transfer by indorsement is a negotiation. If an instrument is payable to bearer, a transfer with or without an indorsement is a negotiation. So the U.C.C. uses "transfer" in a general sense to cover both negotiation and a transfer that is not a negotiation. Using the word "assignment" would distinguish the transfer that is not a negotiation from one that is.

The word "assignment" is recognized as describing the transfer of a negotiable instrument in section 3-202(3) which provides that an indorsement purporting to convey less than the entire instrument or unpaid residue "operates only as a partial assignment." So the U.C.C. indicates that the use of the word to describe a kind of transfer is acceptable.

B. "Order"

Turning to another word, "order", we find that it is used in two senses in the Code. An instrument may contain an order (and be a check or a draft) or a promise (and be a note). So the first sense reflects the kind of instrument involved. On the other hand an instrument may be payable to order or to bearer. So the second sense reflects who may be a holder. Thus an instrument containing an order (a check) may be payable to order or to bearer. The instrument in Parker v. Pledger contained a promise, and it also could have been payable to order or bearer. But it was payable to neither because the name of the payee had been left blank. The court held that it was "not in fact a note" and then cited section 85-3-102(1)(b) as requiring that "the instrument [sic] to whom the promise to pay is addressed must be identified with reasonable certainty." But section 85-3-102(1)(b) refers to

(d) no defense of any party is good against him; and
(e) he has no knowledge of any insolvency proceeding instituted with respect to the maker or acceptor or the drawer of an unaccepted instrument.

9. Id. § 85-3-202(1), supra, note 5.
10. Id.
11. Id.
12. Id. § 85-3-202(3) (1961) provides: "An indorsement is effective for negotiation only when it conveys the entire instrument or any unpaid residue. If it purports to be of less it operates only as a partial assignment."
13. Id. § 85-3-104(1)(b) (1961).
16. 269 Ark. at 930, 601 S.W.2d at 900. The section referred to, Ark. Stat. Ann. § 85-3-102(1)(b) (1961), provides: "An order is a direction to pay and must be more than an authoriza-
an "order" in the first sense above, that where a check is involved. The instrument in this case was meant to be a note and so was governed by section 85-3-102(1)(c) which sets out the requirement of a promise. However the problem is concerned with section 85-3-110 which refers to "order" in the second sense above. It applies to checks and notes both. A blank space does not qualify under section 85-3-110(a) so as to make the instrument payable to order. Nor does it qualify under section 85-3-111 so as to make it payable to bearer. Rather it is an incomplete instrument under section 85-3-115. So the result in the case was correct.

C. "Signature"

The next word is found in a section which provides that "No person is liable on an instrument until his signature appears thereon." How does a "signature" differ from a "name"? In Douglas v. Citizens

tion or request. It must identify the person to pay with reasonable certainty. It may be addressed to one or more such persons jointly or in the alternative but not in succession."

17. Id. § 85-3-102(1)(c) provides: "A promise is an undertaking to pay and must be more than an acknowledgment of an obligation."

18. Id. § 85-3-110(1) provides:

An instrument is payable to order when by its terms it is payable to the order or assigns of any person therein specified with reasonable certainty, or to him or his order, or the like and names a payee. It may be payable to the order of

(a) the maker or drawer; or
(b) the drawee, or
(c) a payee who is not maker, drawer or drawee; or
(d) two [2] or more payees together or in the alternative; or
(e) an estate, trust or fund, in which case it is payable to the order of the representative of such estate, trust or fund or his successors; or
(f) an office; or an officer by his title as such in which case it is payable to the principal but the incumbent of the office or his successor may act as if he or they were the holder; or
(g) a partnership or unincorporated association, in which case it is payable to the partnership or association and may be indorsed or transferred by any person thereto authorized.

19. Id. § 85-3-111 (1961) provides: "An instrument is payable to bearer when by its term it is payable to

(a) bearer or the order of bearer; or
(b) a specified person or bearer; or
(c) cash or the order of cash, or any other indication which does not purport to designate a specific payee."

20. Id. § 85-3-115(1) provides: "When a paper whose contents at the time of signing show that it is intended to become an instrument is signed while still incomplete in any necessary respect it cannot be enforced until completed in accordance with authority given it is effective as completed."

21. Id. § 85-3-401(1), (1961) provides: "No person is liable on an instrument unless his signature appears thereon."
Bank the bank had stamped on the back of a check "pay to any bank—P.E.G. Citizens Bank of Jonesboro, Jonesboro, Arkansas." This was held not to be the bank's acceptance (meaning its signature). Rather the court was convinced by testimony that in the Jonesboro area the stamp served only to identify the bank. This conclusion fits with a definition of "signature" which requires that it be a person's name or symbol of some sort which is put on an instrument with an "intention to authenticate it." In a later case, however, the court held that the issuance of a personal money order bearing the bank's printed name at the top "evidences the [bank's] intent to be bound thereby."

D. "Customer"

Who is a "customer" of a bank as that term is used in Article 4? Part four of the Article is entitled "Relationship between Payor Bank and its Customer." The first six sections refer to the "customer's" rights and duties. The seventh refers to the "drawer or maker" of an item. Usually there is no problem. The customer is the person who opens the account and draws checks on it. So the words "customer" and "drawer" are nearly always interchangeable. But questions have arisen when an account is in the name of a legal entity. For example, banks are liable to "customers" for wrongful dishonor. If a bank wrongfully dishonors a check drawn on a partnership account, is it liable to the partners for harm to them individually or only to the partnership for harm to it? In Arkansas the problem of defining "customer" arose not because of wrongful dishonor but because of alleged wrongful payment out of an account. It was claimed that the plaintiff in a suit against the bank was not a customer. The account was styled "Holiday Inn—Operating Account." The plaintiff had set up the account, with himself as one of three people who were to have authority

22. 244 Ark. 168, 424 S.W.2d 532 (1968).
27. Id. § 85-4-402, (1961).
28. For cases reaching different conclusions, see Loucks v. Albuquerque National Bank, 76 N.M. 735, 418 P.2d 191 (1966) (held that the bank was not liable because the individual partners were not customers) and Kendall Yacht Corp. v. United California Bank, 50 Cal. App. 3d 949, 123 Cal. Rptr. 848 (1975) (distinguished Loucks and held that corporate officers could recover for wrongful dishonor of a corporation check.)
to sign checks on it. The court, citing section 85-4-104, held that he was the "customer . . . but, to say the least, he was certainly as much a customer as" one of the other two with authority to sign and so had a right to complain.\(^\text{30}\)

II. CONTRACT AND PROPERTY RIGHTS IN INSTRUMENTS

In dealing with commercial paper it helps to keep in mind that the subject matter is governed by contract law and property law. As far as contract law is concerned the contracting parties on the instrument promise to do only one thing: pay money.\(^\text{31}\) As far as property law is concerned the parties have rights in a type of personal property, a chose in action. \(^\text{32}\)

A. Contract

Several cases in Arkansas have been concerned with the "contract" nature of an instrument. They remind us that instruments may fail to comply with U.C.C. sections yet remain valid obligations. For instance it is possible to destroy the negotiability of a promissory note by making alterations in its provisions. But as the supreme court pointed out,\(^\text{33}\) that does not render the note invalid. And though most checks are negotiable instruments it is possible for a check not to be negotiable, yet be enforceable.\(^\text{34}\) And even though the U.C.C. permits a bank to refuse to pay a check six months old, the instrument does not

\(^{30}\) Id. at 82, 450 S.W.2d at 302-02.

\(^{31}\) Ark. Stat. Ann. § 85-3-104 (1961) provides in part: "(1) Any writing to be a negotiable instrument within this Article [chapter] must

\(^{32}\) § 85-3-104(1) referring to the contract of the drawer of a check provides: "The drawer engages that upon dishonor of the draft and any necessary notice of dishonor or protest he will pay the amount of the draft to the holder or to any indorser who takes it up. . . ."

\(^{33}\) See also Parker v. Pledger, 269 Ark. 925, 601 S.W.2d 97 (Ark. Ct. App. 1980).

\(^{34}\) Mayes v. State, 264 Ark. 238, 571 S.W.2d 420 (1978).
thereby become a nullity.38 The note and the checks in those cases were still contracts to pay money, obligations of the makers and the drawers.

Another reminder of the contract nature of a negotiable instrument appears when a court holds that the terms of an instrument may be modified by any other written agreement executed as part of the same transaction.39 This holding shows how to determine the total contract of the parties.40 And it is not unusual to find a case where a party is liable for the amount of a note even though not on the note.38

B. Property

Cases have also been concerned with the "property" nature of negotiable instruments. The instruments may be owned and transferred the same as other property.39 If an instrument is negotiable, it may be sold and transferred so that certain bona fide purchasers of it may qualify as holders in due course. A holder in due course has a title to the instrument superior to the title of a former owner who was defrauded out of the instrument or whose loss of it was due to a breach of trust.40 And if the instrument is a bearer instrument, the holder in due course has a title superior even to that of a former owner from whom the instrument was stolen or by whom it was lost. The holder in due course need not repay a maker or drawee who, in discharging the instrument, paid him by mistake,41 unless the holder in due course

38. Mid-South Ins. Co. v. First Nat'l Bank of Ft. Smith, 241 Ark. 935, 410 S.W.2d 873 (1967). This would also be true of a person liable for breach of warranty under Ark. Stat. Ann. § 85-3-417 (1961) in spite of the fact that he did not indorse the instrument. That section does not require a signature for liability to a payor or to a transferee. Of course, there are those who argue that a cause of action for breach of warranty is not for breach of contract but is a hybrid. Such purists may ignore the reference to the Code section, then, but not to Mid-South.
39. There may be a tenancy by the entirety in a promissory note. Ramsey v. Ramsey, 259 Ark. 16, 531 S.W.2d 28 (1975).
Except for recovery of bank payments as provided in the Article on Bank Deposits and Collections (Article 4 [§§ 85-4-101]) and except for liability for breach of warranty on presentment under the preceding section, payment or acceptance of any instrument is final in favor of a holder in due course, or a person who has in good faith changed his position in reliance on the payment.
breaches a warranty in being paid or owes the payor a duty through the payor's subrogation rights. And if he "acts in good faith" the holder in due course is excused from liability under two of the warranties which he would otherwise give to payors. But most often the benefit realized by a holder in due course is his right to be paid by an obligor whose only defense to payment is one classified as a personal defense.

42. The warranties are provided for by Ark. Stat. Ann. § 85-3-417(1) (1961) which reads as follows:

Any person who obtains payment or acceptance and any prior transferor warrants to a person who in good faith pays or accepts that

(a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title; and

(b) he has no knowledge that the signature of the maker or drawer is unauthorized, except that this warranty is not given by a holder in due course acting in good faith

(i) to a maker with respect to the maker's own signature; or

(ii) to a drawer with respect to the drawer's own signature, whether or not the drawer is also the drawee; or

(iii) to an acceptor of a draft if the holder in due course took the draft after the acceptance or obtained the acceptance without knowledge that the drawer's signature was unauthorized; and

(c) the instrument has not been materially altered, except that this warranty is not given by a holder in due course acting in good faith

(i) to the maker of a note; or

(ii) to the drawer of a draft whether or not the drawer is also the drawee; or

(iii) to the acceptor of a draft with respect to an alteration made prior to the acceptance if the holder in due course took the draft after the acceptance, even though the acceptance provided "payable as originally drawn" or equivalent terms; or

(iv) to the acceptor of a draft with respect to an alteration made after the acceptance.

Under Ark. Stat. Ann. § 85-4-207(1) (1961) the same warranties are given to payor banks and other payors when payment is obtained through the bank collection system.


If a payor bank has paid an item over the stop payment order of the drawer or maker or otherwise under circumstances giving a basis for objection by the drawer or maker, to prevent unjust enrichment and only to the extent necessary to prevent loss to the bank by reason of its payment of the item, the payor bank shall be subrogated to the rights

(c) of the drawer or maker against the payee or any other holder of the item with respect to the transaction out of which the item arose.

Such a right (to repayment) would exist against a holder in due course where the drawer had a real defense. This could happen, for instance, where a check was drawn as part of an illegal transaction. For other such defenses see Ark. Stat. Ann. § 85-3-305(2) (1961).

44. Ark. Stat. Ann. § 85-3-417(1)(b) and (c) (1961): supra note 42.

45. Id. § 85-3-305(2) provides:

To the extent that a holder is a holder in due course he takes the instrument free from (2) all defenses of any party to the instrument with whom the holder has not dealt except

(a) infancy, to the extent that it is a defense to a simple contract; and
C. Defenses

The personal defenses are the usual ones that might be asserted in a breach of contract case such as fraud, breach of warranty, want of or failure of (or partial failure of)\(^{46}\) consideration, or non-performance of a condition precedent. A holder in due course will ordinarily take the instrument free of the defense of discharge (except discharge in insolvency proceedings), but he will not if he has notice of the discharge when he takes the instrument.\(^{47}\) Nor will he take free of real defenses.\(^{48}\) These are defenses such as incapacity, illegality, and duress if they cause a contract to be void.\(^{49}\) Real defenses reflect the state's view that the contract is disapproved of so much that nobody should be able to enforce it. As alluded to above, discharge in bankruptcy is a real de-

(b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
(c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
(d) discharge in insolvency proceedings; and
(e) any other discharge of which the holder has notice when he takes the instrument.

§ 85-3-306 provides:
Unless he has the rights of a holder in due course any person takes the instrument subject to
(a) all valid claims to it on the part of any person; and
(b) all defenses of any party which would be available in an action on a simple contract; and
(c) the defenses of want or failure of consideration, non-performance of any condition precedent, non-delivery, or delivery for a special purpose (Section 3-408 [§ 85-3-408]; and
(d) the defense that he or a person through whom he holds the instrument acquired it by theft, or that payment or satisfaction to such holder would be inconsistent with the terms of a restrictive indorsement. The claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon unless the third person himself defends the action for such party.

§ 85-3-408 reiterates § 85-3-306(c), in its first sentence:
Want or failure of consideration is a defense as against any person not having the rights of a holder in due course (Section 3-305 [§ 85-3-305]), except that no consideration is necessary for an instrument or obligation thereon given in payment of or as security for an antecedent obligation of any kind. Nothing in this section shall be taken to displace any statute outside this Act under which a promise is enforceable notwithstanding lack or failure of consideration. Partial failure of consideration is a defense pro tanto whether or not the failure is in an ascertained or liquidated amount.

\(^{46}\) Farmers Co-Op Ass'n Inc. v. Garrison, 248 Ark. 948, 454 S.W.2d 644 (1970). See also the last sentence of § 85-3-408, supra note 44.


\(^{48}\) Id. § 85-3-305(2)(a) through (d), supra note 45.

fense as is forgery\(^{50}\) of the apparent obligor’s name. Unless a party is precluded from asserting real defenses\(^{51}\) they are good against everybody, even holders in due course.

D. *The Holder in Due Course*

To be a holder in due course, one must have a negotiable instrument and he must be a holder of it.\(^{52}\) This means that it must have been negotiated to him.\(^{53}\) Also he must have taken it “for value,\(^{54}\) and in good faith\(^{55}\) and without notice\(^{56}\) that it is overdue or has been dis-

\(^{50}\) Ark. Stat. Ann. § 85-3-401(1) (1961), supra note 21. § 85-3-404(1) provides: “Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it; but it operates as the signature of the unauthorized signer in favor of any person who in good faith pays the instrument or takes it for value.

\(^{51}\) Starkey Construction, Inc. v. Elcon, Inc., 248 Ark. 958, 457 S.W.2d 509 (1970). Ark. Stat. Ann. § 85-3-405 (1961) provides for the preclusion of a person who has been tricked by an imposter or is the victim of a dishonest employee who procures the issuance of instruments in certain ways. § 85-3-406 provides for the preclusion of a person who has been negligent.

\(^{52}\) Ark. Stat. Ann. § 85-3-302(1); § 85-1-201(20); § 85-3-102(1)(e) (1961).

\(^{53}\) Id. § 85-3-202(1).


A holder takes the instrument for value
(a) to the extent that the agreed consideration has been performed or that he acquires a security interest in or a lien on the instrument otherwise than by legal process; or
(b) when he takes the instrument in payment of or as security for an antecedent claim against any person whether or not the claim is due; or
(c) when he gives a negotiable instrument for it or makes an irrevocable commitment to a third person.

\(^{55}\) The requirement of good faith is set out several times to cover transactions involving commercial paper. The holder in due course is required to purchase the instrument in good faith. § 85-3-302(1)(b). This must meet only a subjective test of “honesty in fact in the conduct or transaction concerned.” In addition there is a requirement to act in good faith under § 85-1-203 which provides that “Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.” He may not have any performance required of him since he has usually performed under any (prior) contract that he had—as say a promise to lend money or buy the instrument. Rather he is due a performance by the debtor-drawer (or maker). But he would be involved in enforcement of the contract to pay. Professor Farnsworth differentiates between the two uses of good faith in his article, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. Chi. L. Rev. 666 (1962). The first use—that of §85-3-302(1)(b) is, he points out, “to describe a state of mind: A party is advantaged only if he acted with innocent ignorance or lack of suspicion” *Id.* at 668. The second use—that of §85-1-303 is “to describe performance or enforcement rather than purchase. In this sense ‘good faith’ has nothing to do with state of mind with innocence, suspicion, or notice. Here the inquiry goes to decency, fairness or reasonableness in performance or enforcement. This sense of the term may be characterized as ‘good faith performance’ to distinguish it from ‘good faith purchase’ and is the sense in which ‘good faith’ is used in the general obligation of good faith.” *Id.* at 668. The test to see if there is good faith in the first sense is a subjective one. But “common sense and tradition dictate an objective standard for good faith performance.” *Id.* at 672. These can serve as points of reference as we examine the uses of “good faith” in Article 3. The good faith required by § 85-3-
302(1)(b) comes at the formation or execution stage of the debtor's contract. The first or subjective good faith is also that which is required when paying money for an instrument subsequently enforced against a forger (§ 85-3-404(1), supra, note 50) and taking a check (not postdated) in a way that does not discharge a surety (§ 85-3-802, infra note 133). At the performance stage (of the debtor's performance or the performance of a payor acting in behalf of the debtor, which may be the enforcement of their duty by the holder, unless "enforcement" is limited to that in a court of law) the holder in due course is specifically required to act in good faith when presenting a forged or altered instrument (by § 85-3-417, supra note 42), presenting an instrument for payment when the instrument is forged or when there are not sufficient funds in the debtor's account with the payor (§ 85-3-418, supra note 41), or dating an undated acceptance § 85-3-410(3). And this must refer to the subjective good faith. The holder should not have notice of problems. But this is similar to an innocent warehouseman delivering goods to a thief, which Farnsworth classifies as a "good faith purchase" situation. Id. at 668. And subjective good faith can be required in a performance situation, as when accelerating payment under § 85-1-208. Id. at 672, n. 33. Subjective good faith is required of the opposite party (who pays or satisfies a holder) under § 85-3-603(1)(a) where there is payment following a theft of the instrument. However, although payment is the performance of duty and for some purposes must be distinguished from purchase, on this occasion they are alike in that money is being transferred and the state of mind of the transferor is important. Nevertheless, in two instances there is a requirement of more than just good faith. Both § 85-3-406 and § 85-3-419(3) require in addition that the action (or performance) be in accordance with the reasonable commercial standards of the actor's (or performer's) business. The former governs the good faith of a payor (not a holder) in paying an instrument containing a material alteration where someone's negligence contributed to the alteration. The latter governs the good faith of a representative (who may have been a holder) who has dealt with an instrument or its proceeds on behalf of someone who was not the true owner. And § 85-3-418 in governing the change of position of a person not a holder in due course, following payment of an instrument (supra note 41) seems to deal with subjective good faith conduct after the performance of the contract. But that is from the standpoint of the person being paid and the person paying. If the payment overdraws an account there was performance of a contract. But if the payment is of a forged instrument, from the standpoint of those omnisciently looking at the facts as they really are, and from the standpoint of the drafters, the "performance" is of a non-existent contract. Although the good faith at the time of the purchase of the instrument is subjective, Mid-Continental National Bank v. Bank of Independence, 523 S.W.2d 569, 16 U.C.C. Rep. 1286 (Mo. App. 1975) held that willful ignorance prompted by a desire not to know the true facts negated good faith.

56. ARK. STAT. ANN. § 85-3-304 (1961) provides:

1. The purchaser has notice of a claim or defense if
   (a) the instrument is so incomplete, bears such visible evidence of forgery or alteration, or is otherwise so irregular as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay; or
   (b) the purchaser has notice that the obligation of any party is voidable in whole or in part, or that all parties have been discharged.

2. The purchaser has notice of a claim against the instrument when he has knowledge that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty.

3. The purchaser has notice that an instrument is overdue if he has reason to know
   (a) that any part of the principal amount is overdue or that there is an uncured default in payment of another instrument of the same series; or
   (b) that acceleration of the instrument has been made; or
   (c) that he is taking a demand instrument after demand has been made or more than a reasonable length of time after its issue. A reasonable time for a check drawn and payable within the states and territories of the United States and the District of Colum-
honored, or of any defense, or claim to it on the part of any person.” The Arkansas Supreme Court dealt with one routine case concerning the meaning of notice. Citing section 3-304(4)(d), it held that knowledge that a promissory note had been given to a payee while the instrument was incomplete was not notice to a purchaser that a claim or defense to the note existed; and so the purchaser could be a holder in

bia is presumed to be thirty [30] days.
(4) Knowledge of the following facts does not of itself give the purchaser notice of a defense or claim
(a) that the instrument is antedated or postdated;
(b) that it was issued or negotiated in return for an executory promise or accompanied by a separate agreement, unless the purchaser has notice that a defense or claim has arisen from the term thereof;
(c) that any party has signed for accommodation;
(d) than an incomplete instrument has been completed, unless the purchaser has notice of any improper completion;
(e) that any person negotiating the instrument is or was a fiduciary;
(f) that there has been default in payment of interest on the instrument or in payment of any other instrument, except one of the same series.
(5) The filing or recording of a document does not of itself constitute notice within the provisions of this Article [chapter] to a person who would otherwise be a holder in due course.
(6) To be effective notice must be received at such time and in such manner as to give a reasonable opportunity to act on it.

ARK. STAT. ANN. § 85-1-201(25), (26), and (27) provide:
(25) A person has “notice” of a fact when
(a) he has actual knowledge of it; or
(b) he has received a notice or notification of it; or
(c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.
A person “knows” or has “knowledge” of a fact when he has actual knowledge of it. “Discover” or “learn” or a word or phrase of similar import refers to knowledge rather than to reason to know. The time and circumstances under which a notice or notification may cease to be effective are not determined by this Act.
(26) A person “notifies” or “gives” a notice or notification to another by taking such steps as may be reasonably required to inform the other in ordinary course whether or not such other actually comes to know of it. A person “receives” a notice or notification when
(a) it comes to his attention; or
(b) it is duly delivered at the place of business through which the contract was made or any other place held out by him as the place for receipt of such communications.
(27) Notice, knowledge or a notice or notification received by an organization is effective for a particular transaction from the time when it is brought to the attention of the individual conducting that transaction, and in any event from the time when it would have been brought to his attention if the organization had exercised due diligence.

57. Id. § 85-3-302 (1); Byrd v. Security Bank, 250 Ark. 214, 217, 464 S.W.2d 578, 580 (1971).
59. This is not inconsistent with Parker, 269 Ark. 925, 601 S.W.2d 897 since it can be completed after receipt.
due course. A federal court in Arkansas also dealt with a routine "notice" question and held that knowledge of a bank officer operating in his private capacity could not be imputed to the bank.60

E. Shelter and Reacquiring

Even if a person is not a holder in due course he can get the rights of a holder in due course through the so-called "shelter" doctrine. To encourage the sale of instruments in the hands of a holder in due course (and thus not force him to sue to realize the money owed), the U.C.C. provides that with two exceptions transferees from a holder in due course get the rights of a holder in due course.61 Thus they get as good a title to the instrument as the holder had and they take free of the same defenses that he does. Among such transferees are former holders who are referred to as "reacquirers."62 To see how reacquirers may be sheltered, suppose $P$ fraudulently induces $D$ to make a note payable to $P$. $P$ then makes a gift of the note to $I$, an innocent taker. $P$ is, of course, not a holder in due course because of his fraud. He did not take in good faith and he had notice of his own fraud. Nor is $I$ since $I$ did not give value. So $I$ would be subject to $D$'s defense against $P$ if $I$ tried to collect from $D$. But $I$, who still does not know of the fraud, can negotiate it to $H$ for value and under circumstances that make $H$ a holder in due course. But suppose that when $H$ tries to collect from $D$, $D$ refuses claiming his personal defense of having been defrauded. Rather than sue $D$, $H$ then demands that $I$ pay on his contract of indorsement. When $I$ pays $H$, the instrument is not discharged,63 so $I$ is better off than he was above and has the right to collect from $D$. Since he was not a party to the fraud nor knew of the defense when he sold the note to $H$, he got $H$'s rights of a holder in due course. So he can now collect from $D$, although he would not have been

   (1) Transfer of an instrument vests in the transferee such rights as the transferor has therein, except that a transferee who has himself been a party to any fraud or illegality affecting the instrument or who as a prior holder had notice of a defense or claim against it cannot improve his position by taking from a later holder in due course.
   (2) A transfer of a security interest in an instrument vests the foregoing rights in the transferee to the extent of the interest transferred.
   A fairly recent Arkansas case applied this doctrine. However it involved a note executed in 1959 and so was governed by the Negotiable Instruments Law as enacted in Arkansas. U.S. Fidelity & Guaranty Co. v. Wells, 246 Ark. 255, 437 S.W.2d 797 (1969).
63. Id; Griffith v. Griffith, 250 Ark. 845, 467 S.W.2d 737 (1971).
able to if he had not negotiated the instrument to $H$.

**F. Creating and Transferring Property, and the Influence of Death**

Let us further examine the nature of the property right as it exists in Arkansas, keeping in mind that the reason "property" exists in choses in action is that the courts will enforce them. It may be conceded that a promise which a court will not enforce may be of some value, to the promisee. For instance, $P$ may make a gift promise to his son, and it will not be enforceable for lack of consideration. If, however, the father always keeps his promises, without resort to the court action, the son will still consider the promise of value to him. But for our purposes here we must consider the importance of enforceability. If the law _will_ enforce the promise, then it has value because there are "property" rights in the promise.

It is misleading to say that a drawer of a draft or check or the maker of a promissory note "transfers" property in an instrument when he issues it to the payee. For one thing, a chose in action, if all other efforts to collect fail, may be the subject of a suit against the obligor, that is the drawer or maker. But persons do not sue themselves. So the instrument is not property to a drawer or maker. For another thing, a drawer of a check has a right to stop payment on it. And transferees of instruments are "vested with" the rights of the transferors. By saying that a drawer does not "transfer" a check we avoid giving payees the right to control the stopping of payment.

Perhaps it is best to say that a drawer or maker "creates" property or rights in the payee. But because contract law is interwoven with the creation of this property (or these rights), the limitations of contract rights must be considered. For example if $X$ paint's $Y$'s house as a gift, the increase in value of $Y$'s property is the same as if it had been paid for. And this is a "created" increase; $X$ did not "transfer" the more valuable painted state of the house. But if $X$ "creates" a negotiable instrument and gives it to $Y$, $Y$ does not have an instrument as valuable as one paid for. $Y$ has taken an instrument which is subject to the defense of no consideration and which is thus unenforceable by him if $X$ decides he does not wish that it be paid. On the other hand, if $X$

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wishes that it be paid, the instrument is as valuable to \( Y \) as if it had been bought. So until he presents the instrument for payment, \( Y \) may not know what the true value is.

The way \( Y \) learns of the value or lack of it will depend on the instrument. If it is a note \( Y \) will attempt to collect from \( X \), and if \( X \) decides that it is not to be paid, he will refuse to pay it. If the instrument is a check and \( X \) decides that it is not to be paid, he will order the bank to stop payment. But even if the bank stops payment, \( Y \) may still try to collect from \( X \) after the dishonor. If \( X \) has a change of heart he may pay. If not, \( Y \) can collect nothing. Thus, in the case of the check, \( X \) may twice have to make the decision that it is not to be paid.

Of course property in \( X \)'s instrument can be transferred after \( X \) has issued it. An unqualified indorsement of the instrument by \( Y \) to \( Z \) does two things: it "transfers" \( Y \)'s property right to collect from \( X \) and by contract "creates" in \( Z \) a new property right to collect from \( Y \). To see the significance of this, suppose that \( Y \) paid \( X \) value for the instrument and was a holder in due course, but that \( Z \) took it from \( Y \) as a gift. \( Z \) may enforce the instrument against \( X \) as \( Y \)'s transferee but not against \( Y \) if \( Y \) choses to use his defense of no consideration.

With those two examples let us turn to cases where \( X \)'s intention of paying (at the time of payment) is never known. These are cases where \( X \) has died while his instrument, which was the subject of a gift, is still unpaid. Because \( X \) has died, it cannot be known whether he prefers payment or dishonor. The course that a court might take would be to say that since the instrument was subject to the defense of no consideration, it must hold that the "created" property rights should be destroyed. That is, since no consideration was given, the instrument does not have to be paid, it is not a good claim against the estate, and the personal representative of the estate has a duty to resist the payment out of the assets of the estate. This would indicate a preference for assuming that \( X \) would choose to refuse payment. On the other hand, the court might presume that \( X \) would have paid it had he lived, and thus it would order the personal representative to pay it. In issuing this last order the court has increased the value of the instrument (and because of the doctrine of precedent, other instruments in similar situations) from that which it would have in the first example above ("created" property) to that which it would have in the second example ("transferred" property). The Arkansas court has chosen the second course. It held to be enforceable several instruments which were issued to payees as gifts by persons who died before payment, and it has let the decision as to the payees' title depend upon whether or not the in-
Instruments were bases of gifts *causa mortis*. The background of this rule is found in a series of cases, a few of which will be enough to show the development of the idea.

In the first case, *Hatcher v. Buford*, the decedent had been made the payee of notes which he gave to the plaintiff. The plaintiff was claiming title to the notes against the estate. This was not a suit on the decedent's indorsement, so it was a question of "transferred" property. Once this case was concluded, the winner (the plaintiff or the estate) would collect from the maker of the notes, a living person. This type of property was such that either way the court decided the value would be the same.

A later case, *Lowe v. Hart*, involved a certificate of deposit owned by the decedent. Here the bank was in the same position as the maker of the notes in *Hatcher v. Buford*. The donor was the payee of the certificate and so similar to the payee of the notes. Thus this case also involved "transferred" property. No claim was being brought against the decedent on an obligation as the indorser. The money would be collected from the bank, just as it would be from the maker in *Hatcher*.

The third case, *Carter v. Greenway*, involved checks drawn by the decedent. However, after his death the payees cashed the checks and purchased certificates of deposit. So there was no claim against the estate based on obligations of the decedent. However, one of the counsel had argued that a check could not be the basis of a gift *causa mortis*, and the court responded by stating: "But we think that the better reasoning and the trend of our own authorities, where the rights of creditors are not involved, is that when the delivery of the check is coupled with an intent to transfer a present interest in the money, and no revocation is attempted, the intent of the donor should be given effect, and that the donee has the right to payment of the check after the death of the drawer as well as before." The case cited *Morse on Banks and Banking* (5-Ed.) vol. 2, par. 549, p. 198, to the effect that "In this peculiar case of a check . . . no one but the creditors of the donor have [sic] a right to object. They have a superior equity to the donee . . . . The rule that has grown up is a child of the error that the drawer's death is a revocation of the bank's authority to pay his

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69. 60 Ark. 169, 29 S.W. 641, 27 L.R.A. 507 (1895).
70. 93 Ark. 548, 125 S.W. 1030 (1910).
71. 152 Ark. 339, 238 S.W. 65 (1922).
72. *Id.* at 347, 238 S.W at 67.
checks, and should be banished with its parent. . . . And . . . the theory that said personal representatives are identical with the deceased is groundless; any action they may take against the donee profits, not the deceased, but his heirs and legatees, and therefore the executor or administrator in reality represents said heirs or legatees, and as against them the donee has the superior equity. . . ." 73 The court also cited the Hatcher and Lowe cases.

The fourth case was Smith, Administratrix v. Clark.74 Here, as in Carter, the decedent was the drawer of the checks and as in that case the checks had been paid. So again the suit was not on the drawer's contract. But the court cited Carter for the rule that a check could be the subject of a gift causa mortis.

The case of Burks v. Burks,75 however, put the rule (which up to then was dictum) to use and thereby avoided the defense of no consideration. The decedent was the drawer of the checks in question. She had given them to the payee. Because the drawer had died before they were presented for payment, the bank refused to pay them. The court, relying on Carter, held that the two checks "vested property rights in the payee" (who was thus entitled to payment of money paid into court by the bank). However, this was a case of "created" property. Had the drawer been sued in her lifetime she would have had the defense of no consideration and could have avoided paying. The revocation of the authority of the bank to pay (because of death) is not the crucial issue, contrary to what Morse implied. For had she issued a check which through transfer came into the hands of a holder in due course, any revocation of authority would have applied to that check also. But if the drawee bank had dishonored it, the holder in due course would not have been subject to the estate's personal defenses, including failure of consideration. The estate could not have avoided paying after death any more than the drawer could have before. This case then, admittedly the minority rule, conferred on a donee-payee of a check special property rights not found in most other states.76

In Dailey v. Adams,77 however, the donee did not fare so well. The decedent drew a check 140 days before her death, payable to him, and left instructions that it was to be paid out of her estate. The court held that it was neither a gift inter vivos, nor gift causa mortis. It also held

73. Id. at 347-49, 238 S.W. at 67-68.
74. 219 Ark. 751, 244 S.W.2d 776 (1952).
75. 222 Ark. 97, 257 S.W.2d 369, 38 A.L.R.2d 589 (1953).
76. Id. at 101, 257 S.W.2d at 371.
77. 229 Ark. 571, 319 S.W.2d 34 (1958).
that the check was without consideration, and the claim against the 
estate was disallowed.

These cases all arose before the U.C.C. came into effect. Under
section 4-405, upon the death of a drawer the drawee bank's authority
to pay a check is not revoked "until the bank knows of the fact of death
. . . and has reasonable opportunity to act on it." The implication is
that a short time after a member of the bank's personnel learns of a
drawer's death, the bank's authority to pay his check is revoked. That
is the rule described in the quotation from Morse (cited in Carter,
above) as "error." In a case decided after the Code was in effect, the
court was again concerned with a check drawn by the decedent. It held
that there was not an effective gift causa mortis, though it reaffirmed
that a check could be the subject of one. However, it cited Smith,
Administratrix v. Clark and not Burks v. Burks. The court did not
discuss whether the rule should be reexamined in light of section 4-405.

III. CONCERNING LITIGATION

A. The Choice of Suit

One of the advantages of being the holder of a negotiable instru-
ment is that the Uniform Commercial Code has provisions to simplify
the pleading and procedure of a lawsuit for collection. So it would seem
that if a person is given a negotiable instrument to pay a debt and the
instrument is dishonored, the person would choose the easier course and
sue on the instrument rather than on the debt itself. But as the Arkan-
sas Supreme Court has pointed out, the U.C.C. provides that the credi-
tor may, if he chooses, sue on the underlying debt instead. The debt is
not extinguished when the check is given; the check is not substituted
for it. Rather the debt is suspended, and if the instrument is dishonored
the creditor may choose how he will sue. This does not mean that the
amount owed him is doubled, however. Thus if the creditor sues upon
the debt instead of the instrument he must surrender the instrument in
court to be entitled to a judgment. This protects the defendant by
preventing the instrument's being negotiated to a holder in due
course. The form of pleading also protects the debtor from the instru-
ment's being further negotiated, for the instrument must be attached to

79. Skelton v. Farm Service Co-operative, Inc. 266 Ark. 827, 587 S.W.2d 76 (1979), citing
80. 266 Ark. at 830, 587 S.W.2d at 78.
the pleading or its absence explained. 81

B. The Missing Instrument—Whom Do You Trust?

Sometimes a problem arises because the instrument is missing. Let us consider what is done then. Suppose a client says to his attorney that the instrument has been lost or perhaps unintentionally 82 destroyed. The loss or destruction of an instrument does not destroy the cause of action, but the owner is no longer the holder. 83 What should be done and why?

1. Owning and Holding

To begin with, there is a distinction between being the owner of an instrument and being a holder. Suppose that Otis, who is both owner and the holder of a promissory note, tries upon its dishonor to collect from Mayberry, the maker, but is unsuccessful. Otis then retains Calvin, of Calvin and Associates, Collectors, to collect it for him. He indorses the note to Calvin and delivers it to him. Otis is the owner but no longer qualifies as the holder, since he neither possesses the instrument nor is any longer the indorsee, because Calvin possesses it and is the indorsee.84 Calvin is the holder since he fits the definition. As the Arkansas court has pointed out, the holder need not be the owner. 85 Thus Mayberry can properly pay Calvin and be discharged from the obligation to pay anybody (including Otis) on the instrument. 86 If Mayberry does not pay, Calvin as the holder of the instrument can—in his own name—sue Mayberry. 87 But Calvin's rights on the instrument do not determine ultimately the right to the money coming from Mayberry. Calvin has a contractual duty to pay Otis according to their agreement. Otis was still the owner of the instrument (up until payment) since Calvin took it to collect it instead of buying it.

Suppose the instrument was lost before Otis could negotiate it to Calvin. Again Otis ceases to be the holder because he is no longer in

86. Id.
possession. Who is the holder? No one, because no one fits the definition.

Now return to the supposition above. The client "said" that the instrument was lost. This may be true. But there are at least two other possibilities. It may have been indorsed and given to one Ingrid. If so, Ingrid is the holder. It may have been indorsed in blank and then lost. If it was then found by Ingrid, Ingrid again is the holder. And Ingrid is the person the debtor can safely pay—as Calvin was above. Whichever of the possibilities is true, the Code provides a way both to allow Otis to collect if the instrument is lost—so that the debtor does not go free—and to protect against the possibilities that a holder in due course has the instrument—so that the debtor need not pay twice (once in this suit and again in a suit by a holder in due course such as Ingrid might be). 88

2. A Change in Pleadings

Since the plaintiff is not the holder, he has a harder time with his case than a holder has. He files his pleadings, of course without the original instrument. But he should attach a copy of the instrument if he has one. In this type of case not only must the plaintiff allege and prove his ownership of the instrument, its terms, and the facts that establish the defendant's liability, but he must also allege and prove the facts that explain the absence of the instrument. As the Arkansas court has pointed out, he is not entitled to a judgment if he does not explain its absence. 89 And to protect the debtor against paying twice, the court may require the plaintiff to furnish security sufficient to indemnify the defendant against loss if he has to pay a second time. This can not be avoided by suing on the underlying debt instead, because, as pointed out above, the plaintiff would have to surrender the instrument. He cannot do that if he does not have it.

C. The Ordinary Suit—Pleadings and Evidence

Now let us return to the ordinary suit on an instrument. The plaintiff, if a holder, enjoys certain presumptions. They are found in

88. Id. § 85-3-804 provides:
The owner of an instrument which is lost, whether by destruction, theft or otherwise, may maintain an action in his own name and recover from any party liable thereon upon due proof of his ownership, the facts which prevent his production of the instrument and its terms. The court may require security indemnifying the defendant against loss by reason of further claims on the instrument.

Uniform Commercial Code section 3-307, which first addresses the effectiveness of signatures and the pleadings. If the effectiveness of a signature is questioned because of lack of authorization or lack of proper designation of representative capacity, another section, section 3-403, will govern. And the Arkansas court has discussed the proper pleading needed to address that problem. It decided a case where the signature of the defendant was genuine, but the defendant wished to avoid personal liability by claiming, first, that he had signed in a representative capacity (as an employee of the obligor) and, second, that the payee had agreed that he would not be individually liable. However, the defendant pleaded this by using a general denial. The court held that since the defendant would use testimony in confession and avoidance to escape liability, a general denial was not the proper pleading. Rather, the defendant should have informed the plaintiff of this special defense by pleading the facts constituting such defense. And, as an evidentiary matter in such cases, the burden is on the defendant to prove that the payee agreed that he was not to be liable.

**D. Deaf Before "Dishonor"**

Section 3-307 next concerns establishing defenses. In this connection suppose that the facts are as follows: Dan wrote a check payable to Paul. An unknown person stole it from Paul, forged Paul's signature.

   
   (1) Unless specifically denied in the pleadings each signature on an instrument is admitted. When the effectiveness of a signature is put in issue
   
   (a) the burden of establishing it is on the party claiming under the signature; but
   
   (b) the signature is presumed to be genuine or authorized except where the action is to enforce the obligation of a purported signer who has died or become incompetent before proof is required.
   
   (2) When signatures are admitted or established, production of the instrument entitles a holder to recover on it unless the defendant establishes a defense.
   
   (3) After it is shown that a defense exists a person claiming the rights of a holder in due course has the burden of establishing that he or some person under whom he claims is in all respects a holder in due course.

91. **Chiles v. Mann & Mann, 240 Ark. 527, 400 S.W.2d 667 (1966).**


   [An authorized representative who signs his own name to an instrument] except as otherwise established between the immediate parties, is personally obligated if the instrument names the person represented but does not show that the representative signed in a representative capacity, or if the instrument does not name the person represented but does show that the representative signed in a representative capacity.

93. **Fanning v. Hembree Oil Co., 245 Ark. 825, 434 S.W.2d 822 (1968).**

**Actually this is a plea for a judge not to be deaf to the argument that "dishonor" is the proper term to use. And the party arguing for the use of "dishonor" would be before the judge, not the judge before the party. But the title scans better this way.**
and transferred it to Ingrid. Ingrid indorsed it and sold it to Harold who deposited it for collection. Dan, the drawer, had been warned by Paul, the payee, of the theft; so Dan notified the payor and payment was refused. Harold has sued Ingrid and wishes to collect, claiming that the check has been dishonored (and that a proper notice of dishonor as been sent). Should Harold win if he bases his suit on section 3-414? That section provides that an indorser promises to pay the instrument “upon dishonor.” Ingrid defends claiming there was no “dishonor.” The success of this claim will determine how the plaintiff must prove his case. If she is correct, Harold must prove that Paul’s signature was forged (and that there was a breach of warranty). If she is not, he must prove only that the instrument was not paid and that he promptly notified her. Consider how her argument might run.

To qualify as a dishonor under section 3-507 a refusal to pay must occur when an instrument is duly presented and due payment is refused. The requirement that it be duly presented is met by complying with sections 3-503, 3-504, and 3-505. In brief these sections require

   Unless the indorsement otherwise specifies (as by such words as “without recourse”) every indorser engages that upon dishonor and any necessary notice of dishonor and protest he will pay the instrument according to its tenor at the time of his indorsement to the holder or to any subsequent indorser who takes it up, even though the indorser who takes it up was not obligated to do so.

95. See text at note 103, infra. This can involve the problem and cost of obtaining witnesses qualified to testify as to the validity of the signature.


   (a) a necessary or optional presentment is duly made and due acceptance or payment is refused or cannot be obtained within the prescribed time or in case of bank collections the instrument is seasonably returned by the midnight deadline (Section 4-301 [§ 85-4-301]); . . .
   (3) Return of an instrument for lack of proper indorsement is not dishonor.”

   Unless a different time is expressed in the instrument the time for any presentment is determined as follows:
      (a) where an instrument is payable at or a fixed period after a stated date any presentment for acceptance must be made on before the date it is payable;
      (b) where an instrument is payable after sight it must either be presented for acceptance or negotiated within a reasonable time after date or issue whichever is later;
      (c) where an instrument shows the date on which it is payable presentment for payment is due on that date;
      (d) where an instrument is accelerated presentment for payment is due within a reasonable time after the acceleration;
      (e) with respect to the liability of any secondary party presentment for acceptance or payment of any other instrument is due within a reasonable time after such party becomes liable thereon.
      (2) A reasonable time for presentment is determined by the nature of the instru-
that the presentment by timely, at the right place, and following the right procedure. It would be a weak argument to say that since an instrument bearing a forged indorsement does not entitle the (wrongful) possessor to payment, even though the possessor does not know of the forgery, it should not be presented. And it would therefore be a poor basis for concluding that when it is presented it is not duly presented. But it is not a weak argument to say that in such a case the payment which is refused is for purposes of section 3-507 not due. For

ament, any usage of banking or trade and the facts of the particular case. In the case of an uncertified check which is drawn and payable within the United States and which is not a draft drawn by a bank the following are presumed to be reasonable periods within which to present for payment or to initiate bank collection:

(a) with respect to the liability of the drawer, thirty [30] days after date or issue whichever is later; and

(b) with respect to the liability of an indorser, seven [7] days after his indorsement.

(3) Where any presentment is due on a day which is not a full business day for either the person making presentment or the party to pay or accept, presentment is due on the next following day which is a full business day for both parties.

(4) Presentment to be sufficient must be made at a reasonable hour, and if at a bank during its banking day.

ARK. STAT. ANN. § 85-3-504 (1961) provides:

(1) Presentment is a demand for acceptance or payment made upon the maker, acceptor, drawer or other payor by or on behalf of the holder.

(2) Presentment may be made

(a) by mail, in which event the time of presentment is determined by the time of receipt of the mail; or

(b) through a clearing house; or

(c) at the place of acceptance or payment specified in the instrument or if there be none at the place of business or residence of the party to accept or pay. If neither the party to accept or pay nor anyone authorized to act for him is present or accessible at such place presentment is excused.

(3) It may be made

(a) to any one of two [2] or more makers, acceptors, drawers or other payors; or

(b) to any person who has authority to make or refuse the acceptance or payment.

(4) A draft accepted or a note made payable at a bank in the continental United States must be presented at such bank.

(5) In the cases described in Section 4-210 [§ 85-4-210] presentment may be made in the manner and with the result stated in that section.

ARK. STAT. ANN. § 85-3-505 (1961) provides:

(1) The party to whom presentment is made may without dishonor require

(a) exhibition of the instrument; and

(b) reasonable identification of the person making presentment and evidence of his authority to make it if made for another; and

(c) that the instrument be produced for acceptance or payment at a place specified in it, or if there be none at any place reasonable in the circumstances; and

(d) a signed receipt on the instrument for any partial or full payment and its surrender upon full payment.

(2) Failure to comply with any such requirement invalidates the presentment but the person presenting has a reasonable time in which to comply and the time for acceptance or payment runs from the time of compliance.
surely the section refers to the person who presents the instrument. It will not do to argue that payment was due (to the true owner and that it does not matter that he was not demanding payment). Surely the section means payment not “due to the one presenting.” So Ingrid could claim that since payment was not due, “due payment” was not refused, and there has been no dishonor.

To go further, consider how Ingrid might conduct the case. Having claimed a “dishonor” in his pleadings, Harold has attached the check bearing the evidence of the dishonor. Under section 3-510(b) this may be “the purported stamp or writing of the drawee . . . on the instrument or accompanying it stating that . . . payment has been refused for reasons consistent with dishonor . . . .” But when Harold tries to use the check (or other writing) which bears, as the reason for refusal to pay, the word “Forgery,” Ingrid claims that is not sufficient. For according to Comment 2 to section 3-510 this reason is “not evidence of dishonor, but of justifiable refusal to pay. . . .” Further-

The following are admissible as evidence and create a presumption of dishonor and of any notice of dishonor therein shown:

(a) a document regular in form as provided in the preceding section which purports to be a protest;

(b) the purported stamp or writing of the drawee, payor bank or presenting bank on the instrument or accompanying it stating that acceptance or payment has been refused for reasons consistent with dishonor;

(c) any book or record of the drawee, payor bank, or any collecting bank kept in the usual course of business which shows dishonor, even though there is no evidence of who made the entry.

We may assume that Dan has written Paul (the true owner) a new check and they consider this one a mere piece of paper. Or this “check” may be a copy. See the text following note 88, supra.

100. Comment 2 reads:

2. Paragraph (b) recognizes as the full equivalent of protest the stamp, ticket or other writing of the drawee, payor or presenting bank. The drawee’s statement that payment is refused on account of insufficient funds always has been commercially acceptable as full proof of dishonor. It should be satisfactory evidence in any court. It is therefore made admissible, and creates a presumption of dishonor. The provision applies only where the stamp or writing states reasons for refusal which are consistent with dishonor. Thus the following reasons for refusal are not evidence of dishonor, but of justifiable refusal to pay or accept:

Indorsement missing
Signature missing
Signature illegible
Forgery
Payee altered
Date altered
Post dated
Not on us

On the other hand the following reasons are satisfactory evidence of dishonor, consis-
more, assuming that the meaning of "dishonor" is consistent throughout section 3-510, books and records could not be used instead to prove dishonor, as provided for in (c), 101 because they too would only prove a "justifiable refusal to pay."

Besides the wording of section 3-507(a) and the Comment to section 3-510, Ingrid might find an argument in section 3-507(3) 102 and say that since the proper indorsement of the true owner was lacking, the return of the instrument was not dishonor. It is submitted that the court should reject all three arguments, because if it accepts any of them an unnecessary problem arises.

If there has been no dishonor, Harold must resort to recovery under the warranties of section 3-417(2)(a) and (b). 103 These were breached since under (b) the indorsement was forged and under (a) the forgery prevented Ingrid from getting title. This means that Harold must go to the extra trouble of proving the forgery. He would have to do this if the instrument had been paid and the payor had demanded and received repayment from its transferor. Then the parties prior to the payor would be suing their transferors. In such a case, because of the payment, there would have been no refusal to pay that could serve as "dishonor." But the problem of proof should be avoided as unnecessary when there has been nonpayment. Surely it is desirable to designate the simple evidence of nonpayment as a "dishonor" and to let the nonpayment establish Harold’s case. Consider arguments counter to Ingrid’s, beginning with the more involved argument.

The argument that "dishonor" should include "failure to pay because of forgery" could begin with the statement that the comment to section 3-510 is not law and should be ignored. It is submitted that the statement is a sound one. But for those who will not accept this answer,

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103. Ark. Stat. Ann. § 85-3-417(2)(a) and (b) (1961) provide:

(2) Any person who transfers an instrument and receives consideration warrants to his transferee and if the transfer is by indorsement to any subsequent holder who takes the instrument in good faith that

(a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title and the transfer is otherwise rightful; and

(b) all signatures are genuine or authorized; . . . .
One should argue that “forgery” is out of place among the list of reasons for nonpayment which are said not to be dishonor. The other seven are:

- Indorsement missing
- Signature missing
- Signature illegible
- Payee altered
- Date altered
- Post dated
- Not on us

Each of those reasons is apparent on examination of the instrument. Harold and Ingrid have been put on notice not to try to collect the instrument. Refusal to pay the instrument should have been expected. The four reasons classified as dishonor are:

- Not sufficient funds
- Account garnished
- No account
- Payment stopped

These are matters not apparent to Harold or Ingrid. Nor is a forged indorsement. Harold is not warned to hand the instrument back to Ingrid as an undesirable one. Including forgery on the “dishonor” list promotes a more orderly transfer of instruments. Classifying it as a dishonor is not something that adds an extra burden to Ingrid. The refusal to pay Harold because of a forgery would come as no more of a surprise to Ingrid than a refusal to pay Harold under circumstances that amount to a wrongful dishonor by the bank (as where there is an error as to the balance in an account). Yet such a wrongful refusal is as much a dishonor as a rightful refusal. And Ingrid would have to repay Harold upon proper notice of such nonpayment.

The argument as to section 3-507(3) should be disposed of even more easily. Surely this refers to a blank spot where a name should be, not a forgery.

This then leaves only the problem of the word “due” in section 3-507(1). To allow “dishonor” to be proved where either an indorsement or a drawer’s signature is forged, a court should hold that for this purpose the word “due” includes the meaning “apparently due.” This would allow Harold to argue that there was a dishonor in this case, though he could not argue this if payment was refused for any of the seven other reasons listed in Comment 2 to section 3-510.

An unnecessary problem is avoided in the conduct of the case itself.
if the counter arguments are accepted. Imagine the following course of procedure. Harold files his pleading with the check attached, claiming dishonor. Ingrid moves to dismiss because the check itself, with “Forgery” checked as the reason for nonpayment, shows that there has not been a dishonor. The judge grants the motion, and Harold gives notice that he will appeal the ruling. Harold also will have wisely included a count charging breach of warranty for the forgery. (This will protect him in case some defect in the notice of dishonor is found. Dishonor and notice are not required for breach of warranty suits.) He then proceeds under the breach of warranty count because of forgery. But then notice the situation. Suppose Harold does nothing after proving nonpayment. Since the burden is on him to prove the forgery, the forgery is not proved. Does the judge then rule that there is no forgery? If so, then does Harold move to have the judge change his ruling which dismissed the count claiming dishonor? Surely if the reason there was no dishonor was solely because there was a forgery, then if there was no forgery, the refusal to pay means that there was a dishonor (insofar as this is an issue in this suit between Harold and Ingrid). What we have is a situation where neither party is interested in proving the forgery; certainly Ingrid is not for in so doing she proves herself liable for breach of warranty. To avoid the problem that this presents and to save the time and expense that proof of forgery would otherwise require, the judge should deny the motion to dismiss, declaring that there was a dishonor.

Two more points should be made if a court rules that the word “dishonor” covers “refusal to pay a check bearing a forgery” when the issue is raised in litigation. The ruling should also govern the duties of an indorser under section 3-414 in determining that payment is due before litigation is begun. Otherwise, the holder would have to litigate for the indorser’s payment to him to be rightful, a situation that should be avoided. And, finally, this is not meant as an argument that forgery should be classified as a “dishonor” instead of a breach of warranty; it should be classified as both.

E. **Defenses**

We continue with the litigation process and with the question of defenses under section 3-307. As pointed out earlier, defenses are classified as either real or personal. The defendant can prevail against any

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104. This assumes that he needs to prove it in spite of the stamp on the instrument (or writing) giving the reason for nonpayment.
plaintiff if his defense is classified as a real defense. Such defenses are listed in section 3-305. Although forgery is not listed there it is often thought of as a real defense and is probably the one that occurs the most often. It is not listed because the section refers to "defenses of any party to the instrument" and one whose name is forged is not a party to the instrument. He did not sign it. There are two points brought out in Arkansas cases which concern, first, absence of an authorized signature and, second, absence of any signature. As to the first point, the Uniform Commercial Code specifically provides that an unauthorized signature can be ratified. This could happen, for instance where a person whose signature was unauthorized nevertheless received the proceeds of the instrument. As to the second point, though one whose name is not on an instrument is not liable on it, he may still be liable for the amount of the instrument. This may be established for instance where a suit is being brought against people who are liable on a note, and the party not on the note has assumed liability for payment by a separate agreement. Of course such a claim requires pleadings and proof different from suits on an instrument. It would be treated as a suit on an ordinary contract.

The real defense of infancy has been affected since the passage of the Uniform Commercial Code, in that the Arkansas legislature declared eighteen as the age of majority in 1975. Usury as a real defense has been affected, in that the maximum lawful rate of interest was changed by the passage of Amendment 60 to the Arkansas Constitution in 1982.

Certain illegal contracts are unenforceable as nullities. A negotiable instrument executed to borrow money for gambling, for instance, is "void." Thus the maker of a note so executed has a real defense. The

105. ARK. STAT. ANN. § 85-3-305 (1961), supra note 45.
106. ARK. STAT. ANN. § 85-3-401 (1961), supra note 21, and § 85-3-404, supra note 50.
111. ARK. CONST. amend. 60.
112. ARK. STAT. ANN. § 34-1604 (1961) provides:
   All judgments, conveyances, bonds, bills, notes, securities and contracts, where the consideration or any part thereof is money or property won at any game or gambling device, or any bet, or wager whatever, or for money or property lent to be bet at any gaming or gambling device, or at any sport or pastime whatever, shall be void. This suffices to render the obligation a nullity as required by ARK. STAT. ANN. § 85-3-305(2)(b) (1961), supra note 45.
same is true of a note given by the loser to pay his gambling debt to the winner. However, if the loser borrows money from a third party and uses some of it to pay a gambling debts, this use will not render unenforceable a note given to the third party in return for the loan.\textsuperscript{113}

The defendant whose defense is what is described as a personal defense will prevail if the plaintiff is not a holder in due course. And he will prevail over a holder in due course with whom he has dealt. Personal defenses are listed in section 306.\textsuperscript{114}

The personal defense of discharge occupies an unusual status among the defenses in Article 3. Suppose Ingrid the payee of an instrument has indorsed it over to Harold. Harold then discharges Ingrid from liability on the instrument. Harold then sells the instrument to Paul, a holder in due course, and informs him that Ingrid has been discharged. Under section 3-305(2)(e) Paul takes the instrument subject to Ingrid's "defense" of discharge even though he is a holder in due course (and takes free of any personal defense of the maker to the instrument).\textsuperscript{115} But how can he be a holder in due course? Section 3-302(1)(c) requires a holder in due course to take without notice "of any defense, on the part of any person," and he has notice of Ingrid's defense. One cannot find the answer in Section 3-304(4) which lists several facts, knowledge of which is not notice of a defense. Discharge is not listed.\textsuperscript{116} The conclusion one reaches is either that section 3-302(1)(c) does not really mean what it says or that discharge is a peculiar kind of defense.

The effect of a fraudulent material alteration is to give a special personal defense to any party whose contract is changed by the alteration. This is because the alteration completely discharges the party as against any party other than a holder in due course.\textsuperscript{117} Thus if X is

\textsuperscript{113} Rauch v. First National Bank, 244 Ark. 941, 428 S.W.2d 89 (1968).
\textsuperscript{114} ARK. STAT. ANN. § 85-3-306 (1961), supra note 45.
\textsuperscript{115} Id. § 85-3-305(2)(e) (1961); supra note 45.
\textsuperscript{116} Id. § 85-3-304(4)(1961), supra note 56.
\textsuperscript{117} ARK. STAT. ANN. § 85-3-407 (1961) provides:

(1) Any alteration of an instrument is material which changes the contract of any party thereto in any respect, including any such change in

(a) the number or relations of the parties; or

(b) an incomplete instrument, by completing it otherwise than as authorized; or

(c) the writing as signed, by adding to it or by removing any part of it.

(2) As against any person other than a subsequent holder in due course

(a) alteration by the holder which is both fraudulent and material discharges any party whose contract is thereby changed unless that party assents or is precluded from asserting the defense;

(b) no other alternation discharges any party and the instrument may be enforced according to its original tenor, or as to incomplete instruments according to the authority
given a check for six dollars and he raises it to sixty dollars he cannot collect even the six dollars. However the alteration must be fraudulent as well as material. So correcting a scrivener’s error, for instance, or changing the amount due on a note to reflect a premium for credit life insurance requested after completion of the note, will not discharge the maker of the note.

Use of the defenses can result in penalties to innocent parties if their transferors are insolvent. For instance, if after the fraudulent material alteration above, X transferred the check to someone not a holder in due course (say after the check was overdue or stale) that person could not collect anything either, even though he had not even known of the alteration.

The effect of a penalty can be further illustrated by Pacific National Bank v. Hernreich, a case involving a type of illegality that was a real defense. Hernreich executed some promissory notes payable to W. F. Sebel Co., Inc., a foreign corporation not qualified to do business in Arkansas. The plaintiff, a California bank, was a holder in due course; but the court denied recovery saying Hernreich had a real defense (that Sebel was not qualified to do business). However, the opinion had some weak spots. First, it was based on Arkansas Statutes Annotated section 64-1202 (popularly known as the Wingo Act) which provides that a foreign corporation which is not qualified to do business “cannot make any contract in the State which can be enforced by it either in law or in equity.” And in applying the statute the court cited an article by Dean Waterman and a case on which the dean relied in his article which held that under this statute notes payable to unlicensed corporations cannot be collected by innocent parties to whom the note is sold. However, both the article and the case appeared given.

(3) A subsequent holder in due course may in all cases enforce the instrument according to its original tenor, and when an incomplete instrument has been complete, he may enforce it as completed.

119. Winkle v. Grand Nat'l Bank, 267 Ark. 123, 601 S.W.2d 559 (1980). Note that the court applied Article 3 of the Uniform Commercial Code in spite of the fact that the note was found to be non-negotiable. This is permitted by § 85-3-805 where the reason for non-negotiability is that the instrument “is not payable to order or to bearer.” However, the reason for the non-negotiability in Winkle was that there were “various errors, discrepancies and corrections.” 267 Ark. at 134, 601 S.W.2d at 564.
120. 240 Ark. 114, 398 S.W.2d 221 (1966).
123. Hogan v. Intertype Corp., 136 Ark. 52, 206 S.W. 58 (1918).
before the U.C.C. was enacted, and applied to the Negotiable Instruments Law.

The second weak spot was the court’s statement that “it is settled law that assignees can receive no better rights than their assignors had.” But the plaintiff was not a mere assignor but a holder in due course, and a holder in due course can receive better rights that his indorser had.

The third weakness appeared in a dissent by Justice McFaddin who argued that the logical effect of adoption of the U.C.C. was to allow holders in due course to recover on such notes. He pointed out that prior cases had held the notes voidable and that under section 3-305(2)(b) holders in due course can collect on voidable notes. But he made a doubtful and perhaps erroneous argument that such notes are enforceable in federal courts if the jurisdictional amounts are great enough.

Finally, the majority opinion stated, “To permit enforcement of the notes would in effect repeal our statute.” But this is incorrect. First, it would only have modified the statute since it would have left in force its rule as to all contracts other than commercial paper, and even as to commercial paper where there was no holder in due course. And second, if the court had adopted the dissent’s argument, any modification could be attributed to the legislature itself in adopting the U.C.C., and not to the court; so the legislature would have repealed part of the statute. The effect of the decision was to grant a windfall to the maker of the notes who had done business with the corporation for two decades, and to impose a penalty upon the innocent third party.

F. Not-Really-Weak Links in the Chain of Title

To return to a theme discussed earlier, let us at this point again separate the contract characteristics of an instrument from the property characteristics, and take notice of U.C.C. section 3-207. This

124. 240 Ark. at 117, 398 S.W.2d at 223.
125. 240 Ark. at 119-20, 398 S.W.2d at 224.
126. Id. at 119, 398 S.W.2d at 223. Wood v. Interstate Realty Co., 337 U.S. 535 (1949) indicates that the federal courts would have to follow the Arkansas court. See also Pratt Labs., Inc. v. Teague, 160 F. Supp. 176 (W.D. Ark. 1958).
127. Id. at 118, 398 S.W.2d at 223.
(1) Negotiation is effective to transfer the instrument although the negotiation is
(a) made by an infant, a corporation exceeding its powers, or any other person without capacity; or
(b) obtained by fraud, duress or mistake of any kind; or
section prevents an instrument, part of which is subject to a real defense, from being a complete nullity. Just because a person has a defense that would prevent his being liable on his indorsement, it does not follow that he cannot negotiate an instrument and by that indorsement give good title. Two examples will illustrate this. Suppose a parent executes a check to her fifteen-year old child. The child indorses it over to a third party holder in due course. If payment is stopped, the third party will face the defense of infancy if he sues the child. But the indorsement is sufficient to pass the title to the note so that the third party can enforce it against the parent. Next suppose X gambles his paycheck in a game of dice. He loses and indorses it over to the winner. The winner can enforce the check against the employer, though he cannot enforce it against the employee on the indorsement. 129

To return to Pacific National Bank v. Hernreich, if Hernreich had loaned money to someone and had been the payee on the notes and had then negotiated them to Sebel, Inc., would section 3-207 have allowed Sebel to recover from Hernreich’s borrower (the maker) though not from Hernreich on his indorsement? It should, since section 3-207 is a statute enacted after section 64-1202. 130

IV. SURETYSHIP

Suretyship is defined as follows:

Suretyship is the relation which exists where one person has undertaken an obligation and another person is also under an obligation or other duty to the obligee, who is entitled to but one performance, and as between the two who are bound, one rather than the other should perform. 131

The one who should perform is called the “principal” or “principal

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(c) part of an illegal transaction; or
(d) made in breach of duty.
(2) Except as against a subsequent holder in due course such negotiation is in an appropriate case subject to rescission, the declaration of a constructive trust or any other remedy permitted by law.
129. The rescission, constructive trust, and “other remedy” mentioned in § 85-3-207(2) are rights in the infant and the gambler, not defenses of the parent and the employer. Even these rights do not affect a holder in due course, however.
130. This results from one of two assumptions. The first is that the court would say that Hernreich made the contract (that the Sebel Co. is trying to enforce) with his borrower and that the Sebel Co. is therefore not trying to enforce a contract that it (Sebel) made. The second is that even if the Sebel Co. is viewed as trying to enforce an obligation as a result of a contract that it made, the traditional rule is that the later statute (Ark. Stat. Ann. § 85-3-207, enacted in 1962) prevails over the earlier one (Ark. Stat. Ann. § 64-1202, enacted in 1907 and amended in 1919).
131. Restatement of Security, § 82 (1941).
debtor;” the other party bound is called the “surety” and the obligee is called the “creditor.”

In using abbreviations, the letters “P”, “S”, and “C” respectively refer to the parties in illustrations below.

A. The Parties

Suretyship is not defined in the Uniform Commercial Code, but section 1-103 authorizes resort to the common law for help in determining its relationship to and application to commercial transactions. Certain parties in Article 3 are types of sureties. An “indorser” who does not indorse “without recourse” and who is not an “accommodated party” is one. So are an “accommodation party” and a “guaran-

132. Id. comment a.
   Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

The existence of a surety is recognized in Ark. Stat. Ann. § 85-3-802(2) (1961) which provides: “The taking in good faith of a check which is not postdated does not of itself so extend the time on the original obligation as to discharge a surety.”

134. The contract which makes an indorser liable when another person fails to pay is found in Ark. Stat. Ann. § 85-3-414 (1961), supra note 31. That section excludes those who indorse “without recourse.” An “accommodated party” is a principal and so is obviously not a surety. After an indorser pays he may in turn use § 85-3-414 to collect from prior indorsers. To collect from makers of notes and drawers of drafts and checks, he relies on § 85-3-413 which provides:

(1) The maker or acceptor engages that he will pay the instrument according to its tenor at the time of his engagement or as completed pursuant to Section 3-115 on incomplete instruments.
(2) the drawer engages that upon dishonor of the draft and any necessary notice of dishonor or protest he will pay the amount of the draft to the holder or to any indorser who takes it up. The drawer may disclaim this liability by drawing without recourse.
(3) By making, drawing or accepting the party admits as against all subsequent parties including the drawee the existence of the payee and his then capacity to indorse.


(1) An accommodation party is one who signs the instrument in any capacity for the purpose of lending his name to another party to it.
(2) When the instrument has been taken for value before it is due the accommodation party is liable in the capacity in which he has signed even though the taker knows of the accommodation.
(3) As against a holder in due course and without notice of the accommodation oral proof of the accommodation is not admissible to give the accommodation party the benefit of discharges dependent on his character as such. In other cases the accommodation character may be shown by oral proof.
(4) An indorsement which shows that it is not in the chain of title is notice of its accommodation character.
(5) An accommodation party is not liable to the party accommodated, and if he pays the instrument has a right of recourse on the instrument against such party.
The conditions precedent to the liability of these parties may not be the same; but once the conditions are fulfilled, these sureties are liable for another party's failure to pay an instrument.

An "accommodation indorser" is one who has not owned the instrument. He may appear to have been a holder (as where he indorses after someone who indorses in blank—by signing only one's name) or he may appear to be "anomalous" or "irregular" (as where he indorses after an indorsement, other than a blank indorsement, that does not transfer the instrument to him) but he was not a holder before indorsing. Yet his suretyship duties are the same as regular indorsers. Those duties are conditioned on presentment and dishonor of the instrument and proper notice of dishonor unless waived. On the face

136. Id. § 85-3-416 provides:

85-3-416. Contract of guarantor.—(1) "Payment guaranteed" or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor without resort by the holder to any other party.

(2) "Collection guaranteed" or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor, but only after the holder has reduced his claim against the maker or acceptor to judgment and execution has been returned unsatisfied, or after the maker or acceptor has become insolvent or it is otherwise apparent that it is useless to proceed against him.

(3) Words of guaranty which do not otherwise specify guarantee payment.

(4) No words of guaranty added to the signature of a sole maker or acceptor affect his liability on the instrument. Such words added to the signature of one of two [2] or more makers or acceptors create a presumption that the signature is for the accommodation of the others.

(5) When words of guaranty are used presentment, notice of dishonor and protest are not necessary to charge the user.

(6) Any guaranty written on the instrument is enforceable notwithstanding any statute of frauds.

137. His status will sometimes be obvious. See § 85-3-415(4), supra note 135, concerning notice to later takers of the instrument that such a person has signed it.


(1) Delay in presentment, protest or notice of dishonor is excused when the party is without notice that it is due or when the delay is caused by circumstances beyond his control and he exercises reasonable diligence after the cause of the delay ceases to operate.

(2) Presentment or notice or protest as the case may be is entirely excused when

(a) the party to be charged has waived it expressly or by implication either before or after it is due; or

(b) such party has himself dishonored the instrument or has countermanded payment or otherwise has no reason to expect or right to require that the instrument be accepted or paid; or

(c) by reasonable diligence the presentment or protest cannot be made or the notice given.
of an instrument it may be impossible to tell an "accommodation maker" from a maker who is a principal debtor. But when the accommodation maker is sued by a person other than a holder in due course without notice of his status, he may introduce oral evidence to prove that he is a surety and be entitled to defenses based on his suretyship status.  

B. The Problem Areas

Generally the problems of suretyship arise in answering one of three questions: Is there a suretyship relationship? What defenses may a surety assert? What remedies does a surety have when the time comes for payment of the principal's debt?

1. Establishing the Relationship

The Arkansas court has addressed itself to the first question several times. In *Riegler v. Riegler,* a case arising a few years after the U.C.C. became effective, a wife who had signed a note along with her husband claimed to be an accommodation maker. The note was for a loan of money to build their house. The court distinguished between her receiving a benefit from the note and receiving a benefit for the use of her name. One who receives a benefit from the note is not an accommodation party but a principal. Mrs. Reigler received a benefit from the note since the money was used to build her house. If, however, she had simply been paid money by her husband for signing the note that would have been payment for the use of her name. In such a case she would have been an accommodation party so long as she did not receive any benefits from the note.

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(3) Presentment is also entirely excused when
(a) the maker, acceptor or drawee of any instrument except a documentary draft is dead or in insolvency proceedings instituted after the issue of the instrument; or
(b) acceptance or payment is refused but not for want of proper presentment.
(4) Where a draft has been dishonored by non-acceptance a later presentment for payment and any notice of dishonor and protest for nonpayment are excused unless in the meantime the instrument has been accepted.
(5) A waiver of protest is also a waiver of presentment and of notice of dishonor even though protest is not required.
(6) Where a waiver of presentment or notice of protest is embodied in the instrument itself it is binding upon all parties; but where it is written above the signature of an indorser it binds him only.
Claims of waiver are probably based on (6) more than on any other subsection.
140. *Id.* § 85-3-415(3), *supra* note 135.
141. 244 Ark. 483, 426 S.W.2d 789 (1968).
142. For a set of facts that are similar but that give an opposite result, *see infra* note 195.
Some accommodation parties receive no compensation for signing instruments. They are uncompensated sureties.143 Those who are paid to be sureties are in some ways treated differently from the uncompensated sureties.144 Usually compensated sureties perform services other than being accommodation parties on commercial paper. They may, for instance, issue bonds for the principal's performance and as a result have to pay money when the principal defaults in that performance. A contractor may fail to complete a building, so the company which issued a performance bond will pay money to have it completed. An employee may abscond with the employer's money and the bonding company will reimburse the employer. Since compensated sureties are paid to be sureties, they may find that courts do not treat them with the same sympathy as uncompensated sureties. That is, the defenses to payment available to compensated sureties may not be the same as those available to uncompensated sureties. However, though accommodation parties are often not paid, the court in Reigler left open the possibility that the wife could have been paid yet still have been a surety.

Other cases have examined the benefits that makers were to receive to determine whether those benefits came from the note or from their signing. In one case,145 the parties to a note were seven shareholders of a corporation and two people who were not stockholders. The funds generated by the note were needed by the corporation to exercise an option on property for a shopping center. The two makers who were not stockholders would be benefitted only indirectly by the exercise of the option: they would have received compensation for services if they had arranged financing for the shopping center. These two were held to be accommodation parties while the seven stockholders were held to be principal debtors. In another case,146 one of two stockholders in a corporation signed a promissory note so that the corporation would be extended credit. He was held to be a principal debtor because his primary purpose was to benefit his business interests.

2. Availability of Defenses

The second question, concerning the availability of defenses, has

143. They are also referred to as accommodation sureties. See L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP, 94 (1950).
144. See SIMPSON, supra note 143, 101-12; and RESTATEMENT § 82, supra note 131, comment i.
145. Hanson v. Cheek, 251 Ark. 897, 475 S.W.2d 526 (1972).
two parts. First, which of the principal’s defenses are also available to the surety? Second, what defenses are available to the surety, on his own, based on the relationship?

a. Availability of the Principal’s Defenses

The defense of the principal which the surety most obviously cannot assert is that of discharge in bankruptcy.147 Considering that one of the main reasons for having a surety is to guard against the principal’s inability to pay, for a court to allow this defense would be to exhibit a sense of humor few people in the commercial world would appreciate.

Another defense unavailable to the surety is lack of capacity.148 Again, this is a potential defense of a principal that creditors guard against by having sureties. There are two aspects of the defense worth mentioning though they are now a part of legal history.

First, under Arkansas Statutes Annotated section 68-1601 (1979),149 a minor eighteen years of age or older could not rescind a contract unless he made restitution of the property or the money received by virtue of the contract. But if the minor made restitution, it is possible that this changed the defense from one of infancy to one of discharge. However, this question should no longer arise in Arkansas. After the age of eighteen was made the age of majority,150 the statute was not amended to cover lower ages.

Second, again as a part of legal history, consider the unusual case of a son nineteen years of age who was surety for his parent!161 At the time of the case the age of majority was twenty-one years. The son was an accommodation maker on a note with his mother so that she could buy an automobile. When sued, he tried to raise the defense of infancy. He was held to be subject to the requirement of restitution of the property. Yet the statute required restitution "of the property . . . received by the infant. . . .")152 Surely the property was received by the mother

149. The text appears infra note 152. This has surely been repealed by implication through the passage of 1975 Ark. Acts 892, codified at Ark. Stat. Ann. § 57-103, lowering the age of majority to eighteen.
   In the case of a sale, contract to sell, conditional sale contract, or other contract to which an infant 18 years of age or older is a party, such sale, contract to sell, condi-
and not the son, or the son would, under the rule in *Riegler v. Riegler*, have been a principal debtor rather than an accommodation party. An uncompensated surety receives no property or money and, if able to raise his own defense of incapacity, should be able to do so without making any sort of restitution. However, because of our 1975 statute, this too is a case which should not occur again.

As a general rule if the accommodated party (or principal) has a personal defense good against the holder of an instrument, the accommodation party (or surety) gets the benefit of that defense. Thus if $P$ does not have to pay because he was defrauded, or never received the consideration for his promise, or received a worthless product (breach of warranty), or the instrument was altered, $S$ does not have to pay either.

Discharge in bankruptcy is a real defense, however. And real defenses are ordinarily good even against holders in due course. But we have seen that $S$ must pay the holder although the bankrupt $P$ need not. May a surety assert other real defenses such as illegality (of the kind that voids a contract), duress, or forgery if they are available to the principal? Although no post-U.C.C. cases have appeared in Arkansas involving this question, it would seem that an accommodation maker should get the benefit of the first two defenses. Surely this is true if suit is brought by the payee responsible for the duress or a party to the illegality. These defenses arise because the state considers the conduct so bad that it does not wish to have its courts available for the enforcement of contracts which result from such conduct. But the holder in due course was not a party to that conduct. Should the surety be able to avoid paying him simply because the defense is real? Perhaps the court would look to bankruptcy and incapacity cases for an

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153. 244 Ark. 483, 426 S.W.2d 789 (1968).
155. Note the wording of § 34-1604 in note 111, *supra*. 
analogy. The payee procures the surety's obligation so as to guard against the contingency that bankruptcy or illegality will be raised. But here the remote holder in due course does not take the instrument until after the surety has signed; thus the surety did not sign to assuage the remote holder's fears specifically. Furthermore, lenders foresee the defenses of bankruptcy and infancy. Such defenses are common; they do not involve culpability. Does the possibility of illegality or duress occur to lenders?

A court might decide that the later holder in due course took the instrument relying on the surety's obligation specifically, and foreseeing the possibility of facing the defense of illegality or duress. In such a case it might conclude that these two considerations outweigh the undesirability of allowing the lawsuit against the uncompensated surety. Then again it may not. For a surety may expect to pay a bankrupt's or an infant's debt, yet not expect to answer for someone else's illegality or duress. The court could give more weight to that.

As to illegality and duress, what if S is an accommodation indorser rather than an accommodation maker? The rule should be no different. Under Negotiable Instruments Law section 66 every indorser gave warranties that "the instrument was genuine" and "is at the time of his indorsement valid and subsisting." However, under the U.C.C. an accommodation indorser does not give any warranties since he neither "transfers an instrument and receives consideration" nor "transfers an item and receives settlement." Those terms refer to

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156. *Negotiable Instruments Law*, Sec. 66 provided:
Every indorser who indorses without qualification, warrants to all subsequent holders in due course:

1. The matters and things mentioned in subdivisions one, two, and three of the next preceding section; and

2. That the instrument is at the time of his indorsement valid and subsisting.

And, in addition, he engages that on due presentment, it shall be accepted or paid, or both, as the case may be, according to its tenor, and that if it be dishonored, and the necessary proceedings on dishonor be duly taken, he will pay the amount thereof to the holder, or to any subsequent indorser who may be compelled to pay it.

157. The words "transfers an instrument and receives consideration" are from the warranty section, *Ark. Stat. Ann.* § 85-3-417(2), supra note 8. The words "transfers an item and receives settlement" are from the section granting warranties to banks, *Ark. Stat. Ann.* § 85-4-207(2), which provides in part:
Each customer and collecting bank who transfers an item and receives a settlement or other consideration for its warrants to his transferee and to any subsequent collecting bank who takes the item in good faith that

(a) he has a good title to the item or is authorized to obtain payment or acceptance on behalf of one who has a good title and the transfer is otherwise rightful; and

(b) all signatures are genuine or authorized; and

(c) the item has not been materially altered; and
sellers of the instrument, not to accommodation parties. And although an accommodation indorser, as any other indorser, has a duty to pay following presentment, dishonor, and any necessary notice,\textsuperscript{158} this duty should be interpreted in the same way as that of a maker. The maker has a duty to pay without any such conditions precedent. But that duty is governed by other statutes or by rules of law so that it is excused if there is illegality or duress. The indorser’s duty should be interpreted the same way.

Forgery presents a problem all its own. The situation seems to arise vary rarely. How likely is it that an accommodation party will sign an instrument without checking to see whether or not his principal is actually involved in the transaction? Who would be the forger? Perhaps it would be the payee. Surely he could not recover. The possibility of such forgeries seems remote; however, the defense of forgery did arise in a recent case in Texas, \textit{Universal Metals & Machinery Inc. v. Bohart}\. The court held that guarantors of payment were liable on a forged promissory note, the court describing them as “primary absolute, and unconditional obligors.”\textsuperscript{160} This distinguishes their guaranties from “guaranties of collection” which would not have rendered them liable.\textsuperscript{161} The guarantors were stockholders of the corporation which was supposedly the maker of the note, and the signature that was forged was that of the president of the corporation who was in Mexico. Although the possibility of a surety’s raising the principal’s defense of

\begin{itemize}
\item[(d)] no defense of any party is good against him; and
\item[(e)] he has no knowledge of any insolvency proceeding instituted with respect to the maker or acceptor of [or] the drawer of an unaccepted item. In addition each customer and collecting bank so transferring an item and receiving a settlement or other consideration engages that upon dishonor and any necessary notice of dishonor and protest he will take up the item.
\end{itemize}

An accommodation indorser is never a holder so he does not transfer the instrument. Nor does he receive the consideration or the settlement. That money is received by his accommodated party.

\begin{itemize}
\item[158.] \textit{ARK. STAT. ANN.} \textsection 85-3-414(1), \textit{supra} note 31.
\item[159.] 539 S.W.2d 874 (Tex. 1976).
\item[160.] \textit{id.} at 877.
\item[161.] \textit{See ARK. STAT. ANN.} \textsection 85-3-416 (1961), \textit{supra} note 136. Under (1) the guarantor’s duty arises when the instrument “is not paid when due.” But under (2) the guarantor’s duty does not arise until “it is not paid” \textit{AND} “the holder has reduced his claim against the maker or acceptor to judgment” \textit{AND} “execution has been returned unsatisfied” or “the maker or acceptor has become insolvent” \textit{OR} “it is otherwise apparent that it is useless to proceed against him.” As to the first guarantor, the court \textit{holds} in \textit{Universal Metals} that the reason for nonpayment is immaterial; there is liability. As to the second, the court in its opinion reflects the view that the reason for not reducing the claim to judgment is also immaterial. There was a condition precedent and it was not fulfilled; so there is no liability. And as to its being “apparent that it is useless to proceed,” that must refer to wasting one’s time in trying to collect from an insolvent, not in wasting one’s time trying to collect from one who claims that his name has been forged.
\end{itemize}
forgery may seem remote, several writers have touched on the point.\(^\text{182}\)

b. Availability of Defenses Based on the Relationship

(1) Two Theories

As to suretyship defenses available under Article 3, section 3-606\(^\text{183}\) provides that a surety is discharged by certain acts which impair his recourse against the principal\(^\text{184}\) (or other sureties against whom he

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(1) 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 the instrument or collateral or otherwise discharges such person, except that failure or delay in effecting any required presentment, protest or notice of dishonor with respect to any such person does not discharge any party as to whom presentment, protest or notice of dishonor is effective or unnecessary; or

(b) unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse.

(2) By express reservation of rights against a party with a right of recourse the holder preserves

(a) all his rights against such party as of the time when the instrument was originally due; and

(b) the right of the party to pay the instrument as of that time; and

(c) all rights of such party to recourse against others.

164. His recourse is in equitable remedies usually known by the names exoneration, reimbursement, and subrogation. Ark. Stat. Ann. § 34-330 (1962) provides: "A surety may maintain an action against his principal to compel him to discharge the debt or liability for which the surety is bound, after the same has become due."

This is supplemental to the equitable remedy of exoneration. Rice v. Dorrian, 57 Ark. 541, 544-45, 22 S.W. 213, 214 (1893).


When any bond, bill or note for the payment of money or delivery of property, shall not be paid by the principal debtor, according to the tenor thereof, and such bond, bill or note, or any part thereof, shall be paid by the security, the principal debtor shall refund to the security the amount or value, with interest, thereon, at the rate of ten [10] per centum per annum, from the time of such payment.

Ark. Stat. Ann. § 34-337 provides:

When such payment by a security shall be made in money, such security may recover the value, with the interest, in an action for so much money paid to the use of defendant, and when payment is made in property, he may recover the value, with the interest, in an action for so much property sold to the defendant.

These may supplement the remedy of reimbursement, but not that of subrogation. A surety cannot
has a right of recourse or impair the collateral. The source of the rule is in the common law, and the reasons for it are not clear. One reason (or perhaps a rationalization that came after the rule) was that it was a fair thing to do. If the surety was not compensated, this was an obligation he assumed out of the "goodness of his heart." If he has to pay the creditor he expects to get his money back from the principal or from any collateral that secures the loan. It is unfair to imperil this expectation to any extent by anything that lessens the chance of its fulfillment, since the surety was so kindhearted. And so for the uncompensated surety anything that increases his risk or that materially alters the principal's obligation releases him from any obligation on the instrument. This is called the doctrine of strictissimi juris. If this is the basis, the argument runs, then if a surety is compensated he should not be totally discharged. He should be discharged only to the extent that he has suffered a loss.

Another theory used to justify releasing the surety runs as follows: P, S, and C, entered into a contract. P and C modified the contract—by releasing P or extending time for payment. To do this they rescinded the original contract and entered into a new one. When they rescinded the old contract everyone was discharged. When they entered into the new contract S did not join them so he is not bound by it. This was a novation, and it is basic contract law that one party (or two parties, P and C) cannot force another (here S) into a novation.

be subrogated until he has paid the entire debt. McConnell v. Beattie, 34 Ark. 113, 115 (1879). He can sue for reimbursement if he has paid only part of the debt. 34 Ark. at 116.


When there are two [2] or more securities in such bond, bill or note, and any of them shall pay in money or property, more than his due proportion of the original demand, such security may recover such excess in the same form of action as herein provided for a security against the principal debtor.


No such security shall be compelled in any such action as specified in the preceding section, to pay more than his due proportion of the original demand, and when such security shall have previously paid any part thereof, he shall be liable in such action to pay only so much as the amount already paid by him falls short of his due proportion of the original demand.

The right of the co-surety is recognized by implication in Rauch v. First National Bank, 244 Ark. 941, 428 S.W.2d 89 (1968), a case which allowed it to be waived by a guarantor's consent to the release of another guarantor. It is also recognized in Halford v. Southern Capital Corp., 279 Ark. 261, 650 S.W.2d 580 (1983).

166. Inter-Sport, Inc. v. Wilson, 281 Ark. 56, 661 S.W.2d 367 (1983).

167. For a comparison between the construction of the contract of an accommodation surety and that of a compensated surety, see L. Simpson, supra, note 143, at 94—112.

168. For a further discussion of this theory and that of release because of strictissimi juris, see L. Simpson, supra note 143, at 296-300.
The Arkansas Court of Appeals has indicated that it subscribes to this theory, though not necessarily to the exclusion of the first one. Note two results that flow from it. First, theoretically at least, this rule should apply to compensated sureties as well as uncompensated sureties and release the former as well as the latter. Second, the surety is released even if his risk is not increased but is lessened so that he is even better off than before.

The availability of the defenses can of course, be altered by contract. In one Arkansas case, for example, a party to an instrument (a guarantor) was liable because he had agreed to be so even if another party against whom he had a right of recourse (another guarantor) should be released. In a second case, a guarantor on notes was held liable because he agreed that his liability was not to be affected or impaired by the renewal of the notes.

(2) Extension of Time and Discharge

There are two common methods by which the creditor increases the surety's risk by impairing recourse against the principal or against other co-sureties: extending time for payment and discharging the principal (or any or all of the co-sureties). Both are grounds for discharging a surety under section 3-606. As to the first, extending time for payment, the Arkansas Supreme Court has made clear that an extension of time must be binding to discharge a party under section 3-606. The creditor must do more than just tell the principal he may have more time to pay or simply forbear collection. The reasons can be explained under the strictissimi juris theory. When the debt is due, as will be shown below, the surety has several things he may do to protect himself. If the creditor merely delays collection or makes a promise without receiving any consideration, the creditor is not bound by the promise, but can change his mind and proceed to collect immediately; thus his risk is not increased. So also can the surety take steps to protect himself immediately; thus his risk is not increased, If, however, the creditor and the principal make a binding contract to extend the time

171. Rauch v. First National Bank, 244 Ark. 941, 428 S.W.2d 89 (1968).
174. See the text infra at notes 204 and 217 through 222.
for payment, the debt is no longer due at the original time. So the
surety cannot take steps to protect himself as originally provided. Since
there is a possibility that the principal’s financial condition will worsen
before the new time for payment arises, this means that the surety’s
risk of not being paid is increased. He may have to pay with less hope
of collecting from the principal.

Under the modification of the contract theory, if there is no bind-
ing agreement there is no new contract. But if there is a binding agree-
ment the earlier contract with the earlier time for payment is thereby
rescinded and the surety is released. When the principal and the credi-
tor made the contract with the new (extended) time for payment the
surety was not a party and so was not bound. Under this latter the-
ory the Arkansas Court of Appeals released a guarantor, following a
modification of a contract. However, the case, I.E. Moore v. First Na-
tional Bank of Hot Springs, did not involve a guarantor of a promis-
sory note; it involved a guarantor of a lease.

It is possible to look more favorably on the surety than Arkansas
does. Other jurisdictions have held that the surety is released even
though the extension of time is not binding. This result is reached by
reading section 3-606 closely. It provides that the holder discharges the
surety to the extent that the holder “agrees to suspend the right to
enforce . . . the instrument.” There is no provision that an “agreement”
be a binding contract. Indeed the definition of “agreement” in
section 1-201(11) does not require that it have legal consequences.
This is contrasted with “contract” in section 1-201(11) which does
mean a “legal obligation.”

Section 3-606(2) provides that the surety will not be discharged
if the holder, in discharging a party or extending time for payment,

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179. Id. § 85-1-201(3) provides:
“Agreement” means the bargain of the parties in fact as found in their language or by
implication from other circumstances including course of dealing or usage of trade or
course of performance as provided in this Act (Sections 1-205 and 2-208 [§§85-1-205,
85-2-208]). Whether an agreement has legal consequences is determined by the provi-
sions of this Act, if applicable; otherwise by the law of contracts (Section 1-103 [§85-1-
103]).

Compare “Contract”.

180. Id. § 85-1-201(11) provides: “ ‘Contract’ means the total legal obligation which results
from the parties’ agreement as affected by this Act and any other applicable rules of law.”
Compare “Agreement”.

181. Id. § 85-3-606(2), supra note 163.
resorts to “express reservation of rights.” However, since the surety must not have his risk increased, he may assert his rights and remedies against the principal debtor as if there had been no discharge or extension of time. Thus there is the possibility that where the creditor reserves his rights the surety can render ineffective an attempted discharge or extension by the creditor.

(3) Impairment of Collateral

A third way to increase a surety’s risk is to impair collateral. A loan may be secured both by the contract of surety and by collateral in the form of personal or real property. If there is a default and the surety has to pay the creditor, the surety succeeds to the creditor’s rights and so has a right to use the collateral as a source of repayment just as the creditor had. So he expects the collateral to be available to him in case the principal debtor cannot repay him. Unjustifiable impairment of the collateral, that is anything that lessens its value, increases the surety’s risk and is a ground for discharging the surety; but perhaps the surety should not depend too much on this rule. For one thing “unjustifiable” may be interpreted so that the creditor will not have to undertake “burdensome” acts. And the Arkansas Supreme Court, in two cases decided before the U.C.C. was adopted, had refused to grant a release of the sureties based on failure of the creditor to foreclose mortgages. Foreclosure is “burdensome.” So are other acts. And a creditor may be relieved of an act, though relief may be described in other terms. For instance, in a recent case the court refused to release a surety although the creditor had failed to take any action when the principal debtor did not “deliver” the promised collateral. “Delivery” would have consisted of assigning accounts receivable, which required the rather simple act of the debtor’s signing a security agreement. The creditor had not pursued the matter when the debtor did not deliver. The court said there was no collateral to impair, and the surety was not discharged.

Once a security agreement, mortgage, or deed of trust has been signed giving the creditor a security interest (using the term in a general sense so as to cover both personal and real property) in collateral,

182. Even where there is no contract to this effect, this result follows from the surety’s right of subrogation upon paying the creditor.
183. See L. SIMPSON, supra note 143.
the creditor who wishes to protect his rights against later creditors will perfect the interest by filing in a place of record. But suppose he does not file properly and suppose the surety is called on to pay the debt. If as a result of the failure by the creditor to perfect the interest, another creditor (or a bankruptcy trustee) has priority as to the collateral to what extent is the surety discharged? This question was answered by the Arkansas Court of Appeals in *Van Balen v. Peoples Bank & Trust Co.* The case is worthy of several observations.

The appellants (guarantors) argued that they should have been completely discharged. But the court held that they would be discharged only to the extent that they could prove that the collateral had been impaired by the failure to file. The court pointed out that this has been the rule of all cases decided under the U.C.C. Judge Glaze in a dissent joined by Judge Corbin argued that Arkansas case law has always favored guarantors. He further argued for a rule that was a compromise between *strictissimi juris* resulting in complete discharge and discharge to the extent of provable loss. That rule, which appeared in a recent New Jersey case, *Langeveld v. L.R.Z.H. Corp.* is that if the factual situation is such that the surety can establish that he has been prejudiced but is unable to establish the amount, he should be completely discharged. Judge Glaze pointed out that that was the situation here. The rule would continue to be that if the facts are such that the amount of loss can be proved, the surety should be discharged only to that amount.

The argument is persuasive. For an example, it should not be hard to prove the amount of loss in value of an automobile caused by failure to perfect a security interest because it is not hard to find the value of an automobile. But the collateral in *Van Balen* was several items of property all of which would have to be located and assigned a value. Judge Glaze thought that it was unrealistic to require the surety to do this. Perhaps the appeal of his argument lies in the fact that it is not "burdensome" to file mortgages and financing statements to protect property, but evaluating that property sometimes will be burdensome. And perhaps the courts could consider sureties' burdens too.

The court that decided the *I.E. Moore* case, and completely released the surety was the same one that decided the *Van Balen* case

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188. The unperfected security interest covered furniture, fixtures, and equipment. The collateral was in the hands of the trustee in bankruptcy.
and refused to release the surety. The cases can be distinguished, however. First, *Van Balen* is a case governed by the U.C.C. and *I.E. Moore* is not; and it may be that the protection for sureties was meant to be lessened by the passage of the U.C.C.. The words of section 3-606(1) “The holder discharges any party . . . to the extent that . . .” indicate an intent not to discharge a party completely. In other words, *Van Balen* (unlike *I.E. Moore*) involves statutory interpretation. But an answer to that is that *Langeveld* was also a U.C.C. case, involving interpretation of the same statute; and it presents another possible interpretation.

The second distinction is that *I.E. Moore* involved an alteration in the terms of the original contract. This allows the court to use the theory of “destruction-of-the-original-agreement-followed-by-a-new-contract.” But failure to perfect a security interest or indeed any impairment of collateral is not the substitution of an agreement for one with different terms, but rather concerns the manner of performance of the original agreement. Thus, *I.E. Moore* allowed a complete discharge because it considered the surety’s obligation completely destroyed. But *Van Balen* viewed the matter as enhancing the surety’s risk, and the question was measure of damages. This case was based on the first theory of discharge above. But if Arkansas has favored sureties in the past using that theory would be no obstacle to favoring them now.

A third distinction is that one of the goals of the U.C.C. is uniformity. And *Van Balen*, by adopting the interpretation of section 3-606 that other state courts have also adopted, is a step toward that goal. Yet adopting the *Langeveld* rule in exceptional cases, though viewed in the short run as a step counter to uniformity, could be a trend that other states will follow. Its facts can be distinguished from those in prior cases; thus following it would promote uniformity if other states distinguish those facts too.

Another case concerning the defense of impairment of collateral was *Rushton v. U.M. & M. Credit Corp.* Rushton had failed to prove that he had signed the promissory note in question in a representative capacity and so was personally liable. The note was for equipment and the parties stipulated that “Rushton and Newmark pur-
chased the equipment." Under the rule of the Riegler case, Rushton might not have qualified as an accommodation party. However, the court said that he might seek relief under section 3-606. The creditor had failed to perfect its security interest in the equipment, which was collateral for the loan. The creditor then sold the note to a holder in due course. The lower court held that the collateral was not unjustifiably impaired. On appeal the supreme court affirmed the result, but its reason was that Rushton could have filed under the Code as well as the holder in due course.

This statement raises several questions. Was it not for the original creditor, not the holder in due course, to file the proper papers? Did the holder in due course know of the surety's accommodation status? If not, any defense arising out of the failure to file would be at most the defense of discharge which is a personal defense. And a holder in due course takes free of personal defenses. So the result would have been correct on that ground also.

But the statement that the accommodation party as well as the holder in due course could perfect his interest by filing should be examined for the way it might be interpreted as to future accommodation parties and original creditors. If the suit had been brought by the original creditor, surely the statement as a general rule would not be true. For with certain exceptions, perfection of a security interest in personal property is accomplished by filing a financing statement. This must

193. 245 Ark. at 705, 434 S.W.2d at 82.
194. 244 Ark. 483, 426 S.W.2d 789 (1968).
195. But this is not always so. See, for example, comment 2 to § 85-3-415, in illustrating how an accommodation party may receive compensation: "He may even receive it from the payee, as where A and B buy goods and it is understood that A is to pay for all of them and that B is to sign a note only as surety for A."
197. For a similar observation, see J. White and R. Summers, The Uniform Commercial Code, 529, 141 (2d ed. 1980).
   (1) A financing statement must be filed to perfect all security interests except the following:
   (a) a security interest in collateral in possession of the secured party under Section 9-305 [§ 85-9-305];
   (b) a security interest temporarily perfected in instruments or documents without delivery under Section 9-304 [§ 85-9-304] or in proceeds for a twenty-one (21) day period under Section 9-306 [§ 85-9-306];
   (c) a security interest created by an assignment of a beneficial interest in a trust or a decedent's estate;
   (d) a purchase money security interest in consumer goods; but filing is required for a motor vehicle required to be registered; and fixture filing is required for priority over conflicting interests in fixtures to the extent provided in Section 9-313 [§ 85-9-313];
be signed sometimes by the debtor and sometimes by the creditor, but not by the surety. As a general rule the creditor will be a financial institution with ample copies of financing statement forms and experience in completing and filing them. It has control over the debtor in a way that should make it easy to get his signature on all needed papers. The same will not be true of the usual uncompensated surety. So it is easy to see why failure to file has been held to be impairment of collateral. Failure to perfect (in any way) a security interest in an expensive piece of equipment which results in loss to another who perfects instead (or to a bankruptcy trustee) means the same loss in value as if the creditor had negligently exposed the collateral to theft and it had been stolen. The word "unjustifiably" can still protect the creditor who perfected but, because of an honest mistake of fact, did so in the wrong place.

The moral for an accommodation party must be that he should check to see that the creditor has taken and perfected a security interest in the collateral. Ordinarily, failure on the creditor's part to perfect by filing will have been through oversight, and notification by the accommodation party should be enough to prompt the creditor to file.

The surety's treatment in the loss of collateral cases should be compared to that in a 1976 case in which the guarantor of a note was to be notified promptly if an installment of a note was past due more than fifteen days. The note did not expressly state the consequence of failure. When he was not notified, the supreme court ruled that he was completely discharged, not just to the extent of his loss.

(e) an assignment of accounts which does not alone or in conjunction with other assignments to the same assignee transfer a significant part of the outstanding accounts of the assignor;

(f) a security interest of a collecting bank (Section 4-208 ([§ 85-4-208])) or arising under the Article on Sales (see Section 9-313 ([§ 85-9-113])) or covered in subsection (3) of this section;

(g) an assignment for the benefit of all the creditors of the transferor, and subsequent transfers by the assignee thereunder.

(2) If a secured party assigns a perfected security interest, no filing under this Article [chapter] is required in order to continue the perfected status of the security interest against creditors of and transferees from the original debtor.

199. Id. § 85-9-402(1) provides:

(1) A financing statement is sufficient if it gives the names of the debtor and the secured party, is signed by the debtor, gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral.

3. Rights and Duties at Time for Payment

a. Usual Procedures

Upon arrival of the due date of an instrument, the holder has a right to collect from an accommodation maker. If the surety is a guarantor of payment the principal must first dishonor the instrument and upon dishonor the creditor may proceed against the guarantor.\textsuperscript{201} If the surety is an indorser the creditor must present the instrument to the principal, be refused payment, and give notice of this dishonor to the indorser within a given time—unless these conditions precedent are waived.\textsuperscript{202} Then he may proceed against the indorser. If the surety is a guarantor of collection\textsuperscript{203} the creditor must have reduced his claim against the principal to judgment and had the execution returned unsatisfied (unless following through with the procedure is useless);\textsuperscript{204} then he may proceed against the guarantor.

A surety upon arrival of the due date can bring an action in exoneration against the principal, joining in the creditor, to get a judgment compelling the principal to pay the debt.\textsuperscript{205} This remedy does not appear to have been used in the appellate cases in Arkansas following the passage of the U.C.C.

One of the changes in statutory law which occurred a few years after the U.C.C. went into effect in Arkansas involved another remedy which the surety could pursue without first bringing exoneration or paying the holder of the instrument. Under Arkansas Statutes Annotated sections 34-333 and 34-334, (1962) the surety could by notice in writing require the holder to bring suit against the principal debtor, and if suit were not brought within thirty days and carried through “in due diligence” the surety was discharged from liability. These were frustrating rules. The purpose of having an accommodation maker (or an indorser who waived dishonor and notice of dishonor) on a note is to give the holder his option to proceed against either the accommodation

\begin{itemize}
\item 202. \textit{Id.} § 85-3-414, \textit{supra}, note 31.
\item 203. \textit{Id.} § 85-3-416(2), \textit{supra}, note 136.
\item 204. In Shamburger v. Union Bank of Benton, 8 Ark. Ct. App. 259, 650 S.W.2d 596 (1983), the court describes the obligation as a guaranty agreement without specifying whether it is for payment or for collection. It does, however, state that under the agreement “Union Bank should exhaust all legal remedies before seeking judgment against the guarantor.” 8 Ark. Ct. App. at 261, 650 S.W.2d at 597. So it must have been a guaranty of collection. Shamburger claimed that the bank had 5,000 shares of stock as collateral and that it had never attempted to sell it. There was uncontradicted evidence that the stock was worthless, and the court said that it found no error in the trial judge’s finding that the bank had exhausted all its legal efforts.
\item 205. \textit{See supra} note 164.
\end{itemize}
party or the accommodated party. And the condition precedent to the liability of a guarantor for payment is only dishonor by the principal, not the bringing of a lawsuit. Thus these sections gave the surety a remedy that defeated the creditor's purposes in many cases. They were repealed in 1967.

b. "Tough" Tender, an Interruption

To continue with the surety's rights and remedies when the instrument is due, suppose the surety elects to pay the instrument at the time it is due and proceed against the principal. If the creditor refuses to accept the payment, consider section 85-3-604\textsuperscript{206} which provides:

(1) Any party making tender of full payment to a holder when or after it is due is discharged to the extent of all subsequent liability for interest, costs and attorney's fees.

(2) The holder's refusal of such tender wholly discharges any party who has a right of recourse against the party making the tender.

Why would a creditor refuse tender in the first place? Perhaps because he wanted to allow the principal more time to pay but did not wish to bind himself by granting an extension of time to the principal and reserving his rights against the surety. By not accepting the tender, the creditor prevents the surety from getting rights to, in turn, collect from the principal.

The concern here is with a possible implication from section 85-3-604. The section does not expressly say that refusal of tender by the surety also discharges the surety. Is there then an implication that he is not thereby discharged? There is authority that at common law tender by the surety did discharge him.\textsuperscript{207} Simpson explains the reason that the surety's rights against the principal may be injured by the delay: "He cannot sue the principal for reimbursement, because he has not paid the debt, nor can he, for the same reason, sue the debtor in the creditor's name."\textsuperscript{208} The Restatement of Security section 116 reflects this view in that it provides:

Tender of performance by either principal or surety discharges the surety unless at the time of the tender the creditor reasonably believes


\textsuperscript{208} L. Simpson, supra note 143, at 392.
that the surety is a principal.\textsuperscript{209}

The situation here is significantly different from that covered by the now-repealed sections 33-333 and 33-334. There the surety was discharged by the creditor's failure to sue the principal if the surety notified him in writing to bring the suit when the note came due. The surety thereby avoided an obligation that he had assumed, that he was to be available to pay the debt on the day it was due. But in the tender situation the surety is not only available to pay, he is even trying to perform his obligation. In the first situation the surety was doing the unexpected. In the second the creditor is doing the unexpected.

The situation is also different from tender by the principal. He received a material benefit from the creditor and should not be discharged and avoid payment on such a technicality as would result in unjust enrichment. The principal can, after all, put the money in safe interest-bearing securities or in an insured bank account and wait for the creditor to change his mind. He is protected by subsection (1) of section 85-3-604 from the creditor's earning more interest. His tender redeems his collateral, and he is being held liable as he intended to be from the beginning. But a surety whose tender is refused is in a different position. If he puts his money in safe securities it may be available when the creditor changes his mind, but his actions do not assure that the principal's money—meant to reimburse him for any payment—will also be available.

Since the consequences of the surety's tender will depend on the interpretation of section 85-3-604, the possible interpretations need to be considered. Consider how the discharge of the surety might have been provided for. Section 85-3-604(1) could have added "and if he is a party with a right of recourse against another he is wholly discharged." Does the absence of such a clause from subsection (1) force an implication that the surety is not discharged by tender? The comment says that the subsection "states the generally accepted rule as to the effect of tender."\textsuperscript{210} That may be a slender thread for those who contend that the comments are not law. But to the extent that it indicates the intent of the draftsmen, and considering the rule as stated by Simpson and the Restatement, one can conclude that subsection (1) is not meant by implication to forbid "wholly discharging" a tendering surety.

What then of subsection (2)? It could have added "and wholly

\textsuperscript{209} \textit{Restatement of Security}, § 116 (1941).

\textsuperscript{210} \textit{Ark. Stat. Ann.} § 85-3-604 comment 1.
discharges a surety making the tender." Does the absence of such a clause force an implication that the surety is not discharged by tender?\footnote{211}{Jessee v. First Nat. Bank of Atlanta, 154 Ga. App. 209, 267 S.E. 2d 803 (1980), seems to conclude this. The surety complained that this interpretation would cause him to lose his right to subrogation anyway. See Arkansas's rule on this in note 164, supra, and the text at note 220, infra. In addition, \S\ 3-604 requires tender of full payment.} Not necessarily. It may have been that the discharge of the surety in such a situation was so obvious to the draftsmen that they did not think the rule needed to be included. The comment tells us that it "rewords the original subsection 120(4)."\footnote{212}{\textsc{Ark. Stat. Ann.} \S\ 85-3-604 comment 2.} That subsection discharged a party "secondarily liable" on the instrument when there was a tender by an accommodated party who was prior to the secondary party.\footnote{213}{\textsc{Negotiable Instruments Law} \S\ 120(4) provided: "A person secondarily liable on the instrument is discharged:

4. By a valid tender of payment made by a prior party..."} Section 85-3-604(2) discharges a party by tender of an accommodated party who is subsequent as well as by one who was prior. Thus if the surety is an accommodation maker and the principal, or accommodated party, is the payee-indorser (that is, subsequent), tender of payment by the payee-indorser discharges the maker. This was not covered by subsection 120(4). So the section was meant to extend further protection to a surety, not limit the protection he then had. And in the days of the N.I.L., when the more limited protection was in effect, the surety was discharged by his own tender of payment.\footnote{214}{L. Simpson, \textit{supra} note 143, at 392. Simpson's book was published in 1950 before any state had adopted the U.C.C. And the Restatement, with section 116, appeared in 1941.}

The failure to discharge a surety who tenders full payment to the creditor can lead to a situation that is ludicrous. To see how this could happen consider a loan secured by two co-sureties (Surety \textit{A} and Surety \textit{B}) on an instrument. Suppose that either is liable to the creditor for the full amount, and each is to be liable to the other, if the other has to pay, for half the debt. That means that if either one has to pay the full amount, he will have recourse against the other in an action for contribution.\footnote{215}{See \textit{supra} note 165.} Now suppose that Surety \textit{A} tenders full payment to the creditor and the tender is refused. Since either co-surety has recourse against the other, that means that Surety \textit{B} has recourse against Surety \textit{A}, and Surety \textit{A} has recourse against Surety \textit{B}. Then under section 85-3-604(2) the refusal discharges Surety \textit{B} since Surety \textit{B} has recourse against Surety \textit{A}. In the alternative, if Surety \textit{B} tenders full payment, Surety \textit{A} is discharged. That then leaves one of two possibilities, either
the tendering surety is also discharged or he is not. Let us consider the possibility of discharge first. To argue that Surety $A$ is also discharged, we would use section 85-3-606(1)(a)\textsuperscript{216} which provides that a party is discharged by the "holder" (in this case the creditor) when the holder "releases" a person against whom the party has a right of recourse. If the creditor's refusal discharges Surety $B$, the creditor by this act "releases" Surety $B$. And since as we saw in the above paragraph Surety $A$ has a right of recourse against Surety $B$ right up to the time of the discharge, the release discharges Surety $A$. If this is true, and if a single surety is not discharged by his own tender, then in regard to discharge the result of a surety's tender depends upon how many sureties there are. Surely the drafters did not intend that result.

Now let us consider the possibility that Surety $A$ is not discharged by his tender, but that Surety $B$ is discharged. This means that a subsequent tender of full payment by Surety $B$, to return the favor, will not in turn discharge Surety $A$. For if $B$ is discharged $A$ no longer has a right of recourse against him, and hence $A$ cannot qualify to be discharged under section 85-3-604(2). Surety $B$ faces the same prospect if he tenders first. Which generous soul then makes the tender? Do they toss a coin or draw straws? Surely the drafters did not intend this dilemma either. Does the answer lie in an absurd ritual? Imagine both sureties walking up to the creditor at the same time. They chant together proper words of tender, being careful to say, "I hereby tender in full payment of a debt . . . ." and so on, until they finish together ending with words such as "failure to accept will be taken as refusal." If the creditor then does not accept from one of them has he not refused each so that each is discharged by the other's act and the refusal? Is this fair to the single surety who has nobody to play such a silly scene with?

The simplest solution is to suppose that the Code drafters never intended this result and to rule that a surety is discharged when his own tender is refused. The section need not be interpreted so as to prevent the surety's discharge. It certainly does not expressly forbid the discharge, and if one chooses to say that the section does not rule either way, resort to section 1-103 will allow the matter to be governed by the law of suretyship in general. Under that law the surety is discharged. However, it may be that the attitude of the courts toward the uncompensated surety is changing and that the courts are less sympathetic toward him than before. It may be that courts favor the uncompens-

sated surety's discharge only to the extent of his loss. If that is so, surely in a case such as this where the creditor's conduct is so aberrational, there should be a presumption that the surety was harmed to the full extent of his obligation. That would put the burden on the creditor to prove the extent to which the surety was not harmed by the creditor's refusal of tender.

c. Back to Normal Procedures

Return now to the normal situation. If the creditor accepts the tender made by a surety, the surety then has several rights that he may exercise to seek repayment. If there were other sureties, co-sureties, who agreed to assume a pro rata share of the obligation, the surety who pays the creditor the full amount of the debt has a right to collect on those agreements. The term for his right is "contribution." The cases do not reveal that the Arkansas courts have had to deal with legal problems concerning the exercise of this right in commercial paper.

In proceeding against the principal debtor, an accommodation party may proceed on the instrument. This cause of action combines (without replacing) two rights a surety has in equity, the right of subrogation and the right to reimbursement. The first can be described as an equitable assignment of the creditor's claim against the principal. The surety must pay the entire debt, and he is then subject to the same defenses and gets almost the same rights as the creditor. The word "almost" is used because there is a possibility that a surety who pays off the creditor at a discount will not be subrogated to the full amount. However, the surety may resort to his second right, reimbursement, even though he has not paid off the entire debt. The theory of recovery here is not that he has been "assigned" the creditor's claim but that the principal has impliedly promised to repay him for paying the debt. The suit on the instrument does not arise from a new right. And so, for instance if the surety who has paid is suing for the whole debt, this is a subrogation suit using the procedure of a suit on a nego-

217. Id.
220. See supra note 164.
221. See Peters, supra note 162, at 869. There is a hint to this effect in Hanson v. Cheek, 251 Ark. 897, 475 S.W.2d 526 (1972) when the court concludes that "the appellees are accommodation endorsers with the right of recourse to recover from the appellants any payment appellees make upon the note." 251 Ark. at 900, 475 S.W.2d at 528 (emphasis supplied). This may mean that they cannot collect the full amount of the note by paying less.
tiable instrument. And the suit will be governed by the rule that subro-
gation is "steeped in equity and generally governed by equitable
principles."222

V. TAKE THE MONEY AND RUN—AN UNUSUAL
ARKANSAS STATUTE

Section 4-105(d) of the Uniform Commercial Code provides:
"'Collecting bank' means any bank handling the item for collection
except the payor bank. . . ."

However, in 1967 the Arkansas legislature amended this to pro-
vide: "'Collecting bank' means any bank handling the item for
collection. . . ."223

One conclusion that may be drawn is that now "collecting bank"
includes the payor bank. The reason for this change does not appear in
the Act itself, which makes several changes and which begins: "An Act
to Amend Act 185 of 1961, the Commercial Code, to Make the Same
Conform more Closely to the Uniform Code; to Correct Certain Cleri-
cal Errors in Said Act, and for Other Purposes."224

This change however, makes this section conform less closely, not
more, to the U.C.C.; and the original wording did not contain a clerical
error. Moreover, the change produces confusion without any apparent
benefit because it raises the question: Did Arkansas intend to abolish
the doctrine of Price v. Neal?225

To understand the significance of this, consider a bank's payment
of a check by mistake. Most payments by mistake by a bank, under
circumstances where checks should not be paid, fall into one (or more)
of four fact situations:

1. The drawer did not have enough money in his account to cover
the check.
2. The drawer ordered payment stopped but the order was
overlooked.
3. The drawer's name was forged.
4. An indorsement necessary for title was forged.

After the mistake is discovered, assuming that the person paid had
no knowledge that payment was by mistake, in two of the situations the

334, 335, 595 S.W.2d 938, 939 (1980).
bank can recover from the person it paid. The U.C.C. provides for recovery from the person paid in case of a forged indorsement\(^\text{226}\) and in case of an overlooked stop order (unless the person paid could have collected from the drawer anyway).\(^\text{227}\) But if the person "finally" paid is a holder in due course or has in good faith changed his position in reliance, recovery is not provided for if the account does not have the funds or if the drawer’s name is forged.\(^\text{228}\)

The rule that payment may not be recovered where payment was over a forged drawer’s signature is "the rule of Price v. Neal." To understand the relationship between section 4-105(d) and "the rule of Price v. Neal," it may be helpful to have a legal description of what happens, within the context of section 4-207, when checks are purchased or paid. For recovery is based on section 4-207.

Suppose that Dan has an account in the Big Bank. He draws a check for fifty dollars payable to Paul. It is stolen from Paul, his indorsement is forged, and the thief transfers the check to the Little

\begin{footnotes}
\footnote{226. ARK. STAT. ANN. § 85-3-417(1)(a) (1961) provides:}
\footnote{Any person who obtains payment or acceptance and any prior transferor warrants to a person who in good faith pays or accepts that (a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title;}
\footnote{And for payor banks § 85-4-207(1)(a) provides:}
\footnote{Each customer or collecting bank who obtains payment or acceptance of an item and each prior customer and collecting bank warrants to the payor bank or other payor who in good faith pays or accepts the item that (a) he has a good title to the item or is authorized to obtain payment or acceptance on behalf of one who has a good title;}
\footnote{227. Id. § 85-4-407(c) provides:}
\footnote{If a payor bank has paid an item over the stop payment order of the drawer or maker or otherwise under circumstances giving a basis for objection by the drawer or maker, to prevent unjust enrichment and only to the extent necessary to prevent loss to the bank by reason of its payment of the item, the payor bank shall be subrogated to the rights . . . (c) of the drawer or maker against the payee or any other holder of the item with respect to the transaction out of which the item arose.}
\footnote{228. Id § 85-3-418, supra note 41. And for bank collections, § 85-4-213(1) provides:}
\footnote{An item is finally paid by a payor bank when the bank has done any of the following, whichever happens first: (a) paid the item in cash; or (b) settled for the item without reserving a right to revoke the settlement and without having such right under statute [J clearing house rule or agreement; or (c) completed the process of posting the item to the indicated account of the drawer, maker or other person to be charged therewith; or (d) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing house rule or agreement. Upon final payment under subparagraphs (b), (c) or (d) the payor bank shall be accountable for the amount of the item.}
\end{footnotes}
Store for goods. The owner of the Little Store takes it to the Other Bank (where the Little Store's account is), indorses the check and receives fifty dollars cash. For purposes of section 4-207(2)(a) and (b), the Little Store is a "customer," the check is an "item," the item was "transferred," and the Little Store "received consideration" and "warranted" to the Other Bank that it had good title (and also that Paul's signature was genuine).229 Suppose further that the theft is not discovered and that the check is paid by the Big Bank to the Other Bank. For the transaction between the two banks the U.C.C. uses other words, and the rules of section 4-207(1)30 come into play. The Other Bank is a "collecting bank" but it did not "transfer" and "receive a settlement or other consideration." Instead it "obtain[ed] payment." In this case, however, the same critical warranty that the Little Store gave to the Other Bank—the warranty of title—is given by the Other Bank to the Big Bank; and so we have a situation where the Little Store is liable to the Other Bank, and the Other Bank is liable to the Big Bank. Because the indorsement was forged, there was a breach of the warranty of title.

Now, however, imagine a *Price v. Neal* situation. Dan's employee, Paul, forges Dan's name to a check for fifty dollars made out to the employee, and the employee exchanges it for goods at the Little Store after indorsing it. Again the Little Store collects money from the Other Bank, and the Other Bank is paid by the Big Bank. This time there is no breach of warranty of title, however, because there was no forged indorsement. The check was payable to the employee, and he indorsed it. So the indorsement was proper although the name of the drawer was forged. Also, although both the Little Store and the Other Bank were indorsers, their indorsements were not forged. What the Other Bank did was to present to the Big Bank a check to which it had good title, but which should have been charged to the employee's account, if he had one.231 Because there was no breach of warranty, the Other Bank is not obligated to repay the Big Bank. Nor is it obligated to pay in a

229. *Id.* § 85-4-207(2)(a) and (b) provides:
(2) Each customer and collecting bank who transfers an item and receives a settlement or other consideration for it warrants to his transferee and to any subsequent collecting bank who takes the item in good faith that
(a) he has a good title to the item or is authorized to obtain payment or acceptance on behalf of one who has a good title and the transfer is otherwise rightful; and
(b) all signature are genuine or authorized;


common-law restitution action, and the Other Bank will not demand payment from the Little Store.

One more step will be necessary to see the significance of section 4-105(d). Suppose that instead of the check’s being paid as in the paragraph above, Dan had discovered the stolen check and forgery, had ordered payment stopped, and the Big Bank had refused to pay the Other Bank. Although the Big Bank could not have recovered from the Other Bank the money it paid without knowledge that Dan’s signature was forged (as in the paragraph above), the Other Bank in this instance (where the Big Bank did not pay) can recover from the Little Store the fifty dollars cash. The reason is that the Little Store warranted to its transferee that all signatures were genuine (and that included Dan’s) while the Other Bank did not warrant this to the Big Bank when it was paid in the paragraph above.

Under Arkansas’s version of section 4-105(d), unlike that in the rest of the country, “collecting banks” include “payor banks”. So it could be argued that the Big Bank is thereby (as a collecting bank) given rights against the Little Store, since the warranty of section 85-4-207(2)(b) because of the change in wording runs to it as well as the Other Bank. This is because the warranty runs not only to the Little Store’s “transferee” (the Other Bank) but also to “any subsequent collecting bank.” However, it is submitted that this argument should fail. In the Arkansas version of the U.C.C. as well as the official text, warranties to a payor and warranties to a transferee are kept separate. They are also kept separate in the Article 3 equivalent of section 85-4-207, which is section 85-3-417. Section 85-3-417 applied when the employee negotiated the check to Little Store, because the transferee was not a bank. That section used the words “payment,” “pays,” “transfers,” and “transferee” just as section 4-207 does, but uses and “any subsequent holder” rather than “any subsequent collecting bank.”

232. Restatement of Restitution § 30 (1937) provides:
   The holder of a bill of exchange or promissory note who has received payment thereof from one whose name was forged thereon as a party, or from a drawee on a bill on which the drawer’s name was forged, is not thereby under a duty of restitution if he paid value and received payment without reason to know that the signature was forged.


234. Id. § 85-4-207(1), supra note 226.

235. Id. § 85-3-417(1), supra note 226.

236. Id. § 85-3-417(2) provides:
   (2) Any person who transfers an instrument and receives consideration warrants to his transferee and if the transfer is by indorsement to any subsequent holder who takes the instrument in good faith that
   (a) he has a good title to the instrument or is authorized to obtain payment or accept-
By keeping the warranties of section 3-417(1) separate from those of section 3-417(2) and the warranties of section 4-207(1) separate from those of section 4-207(2), the U.C.C. makes it very plain that payors of instruments whether individual human beings or banks do not get the same rights as purchasers of the instruments. For purposes of interpreting those sections, it must follow that “paying an item” is not “taking an item”, “obtaining payment” is not “transferring an instrument”, and “a person who pays” is neither a “transferee” nor a “holder.”

One minor problem might arise in interpreting the words of section 3-417(1) and section 4-207(1) when Dan’s signature has been forged by Paul. Suppose Paul does not have an account with the Big Bank. The Big Bank having paid The Other Bank has a right to collect (arguably on the check) against Paul, the forger of Dan’s name. Can it, then, be argued from that, that the check only “seemed to be” paid? Can it be said that in fact it was “purchased” by the Big Bank? If so, the warranties of section 3-417(2) and section 4-207(2) do apply. The answer is that, in the law at least, in this instance, “seeming to be paid” is the same as being paid. Mistaken payment is still payment. It must be “payment” as far as the U.C.C. is concerned, or neither section 3-417(1)(a) nor section 4-207(a) would ever apply. Those subsections allow for recovery after a mistaken payment to one without title by imposing liability on the one who “obtains payment.” And mistaken payment is still payment under both the U.C.C. and the law of restitution or there is no need for the rules that payment is final though mistaken.

One can turn to sections other than section 4-105(d) and conclude that in amending that section, the Arkansas Legislature did not intend to abolish the rule of Price v. Neal. A simple and obvious way of abolishing the rule would have been to amend section 3-417(1) and section 4-207(1) to add to them the warranty of section 3-417(2)(b) and section 4-207(2)(b) that “all signatures are genuine and authorized.” It

ance on behalf of one who has a good title and the transfer is otherwise rightful; and
(b) all signatures are genuine or authorized...  
237. This means that a payor in its position as a payor cannot be a holder. A person who, for instance, buys travelers checks at his bank can make the payor the payee of his own personal check given in payment. Ark. Stat. Ann. § 85-3-110(1)(b) (1961), supra, note 14. He may also have his account in the same bank as his employer and when cashing his paycheck indorse it to the bank. In the first case he creates property in the bank; in the second he transfers property to the bank. And in either case the payor is a holder. But when either check is paid, the payor wears two hats. It does not by paying itself become a holder.

did not do so. Second, the legislature could have provided for recovery of payments in a separate section, as it provided for recovery in section 4-407\textsuperscript{239} (which allows subrogation when stop orders are overlooked), and in that separate section it could have specifically allowed a right of action after payments over forgeries. It did not do that either. As a third possibility, the legislature could have excepted payment in case of forgery from the final payment rules of section 3-418 and section 4-213(1) but it did not. Surely had the legislature meant to change the rule it would have resorted to one of these simpler and more direct methods of doing so, rather than using such an indirect method as altering section 4-105(d). One must conclude that the reason for the alteration lies somewhere else. This author has not yet determined what that reason was, however.

A final observation on this dilemma may be in order. The rule of \textit{Price v. Neal} may be changed in Arkansas in the years ahead. It may be abolished, depending on the final version of the New Uniform Payments Code. This Code is being drafted to amend or replace Articles 3 and 4 of the U.C.C. An underlying objective is to establish uniform rules for all types of funds, whether paper is used or a card is used or the transfer is electronic. One of the results would be that risk among parties would be based on tort rather than warranty principles. The person who transmits an unauthorized order to pay money—using a check or a card or sending it electronically—would be liable to all parties “who pay or give value in exchange for the order.” Thus all payors as well as transferees could recover for having given money for forged instruments.\textsuperscript{240} Banks should be happier, the rules will be simpler, over two hundred years of legal history will be immaterial, and law professors will have to use something else to fill a time slot in the Commercial Paper course.

\textbf{CONCLUSION}

These reflections on the developments of Arkansas law concerning commercial paper over the past two decades have focused on five areas—words, property and contractual rights, litigation, suretyship, and one aspect of the check collection process. This is but one way of organizing most of the cases and statutes concerning commercial paper that have appeared in the past twenty years and but one way of discussing the present state of this area of commercial law in Arkansas.

\textsuperscript{239} ARK. STAT. ANN. §§85-4-407(1)(c), \textit{supra} note 227.
\textsuperscript{240} For further discussion of this, see Benfield, \textit{supra} note 3.
Except in a few areas such as the case law which enforces gift checks, and statutory law which does not except payors from those banks in the check collection process known as "collecting banks," the law in Arkansas is similar to that in the rest of the United States.

Any attempt to speculate on what this law will be like twenty years from now would certainly have to consider the rapid changes in technology. Payments and short-term borrowings are even now accomplished using plastic cards and electronic equipment as well as paper and pens. Will longer term borrowing continue to involve signing a promissory note written on a piece of paper? And before wondering what will happen to the concept of negotiability (and its beneficiary, the holder in due course) we must remind ourselves where it is now. The U.C.C. lists four negotiable instruments: drafts, checks, certificates of deposit, and notes.\(^2\)\(^4\)\(^2\) As for drafts and checks, the Arkansas Legislature recently indicated that certain of these must continue to be negotiable.\(^2\)\(^4\)\(^2\) However, today there are certificates of deposit that are not only not negotiable but also not transferable. And the negotiability of promissory notes in consumer transactions is being limited, but then Arkansas had limited it during pre-Code days.\(^2\)\(^4\)\(^3\)

We can guess that the focus of "borrowing and paying" law will be different. We can hope that it will be easier to understand. Because we may suspect that with rapid changes in technology the law may in the future change more quickly than before. And we will wonder if we are going to have to learn new rules even faster.


Hereafter, all claims paid by any insurer authorized to do business in this State to any person having a claim under any insurance contract for any type or types of insurance authorized by the laws of this State issued by such insurer, shall be paid by check or draft of the insurer to the order of the claimant to whom payment of the claim is due pursuant to the policy provisions.

The reason is found in the section following it. \textit{Ark. Stat. Ann.} § 66-2018 (Supp. 1983) provides:

No insurer shall intentionally or unreasonably delay, for more than three [3] business days after presentment for collection, the processing of any properly executed and endorsed check or draft issued in settlement of an insurance claim. It is the intent of the General Assembly that insureds or claimants shall be paid for their settlement proceeds at the earliest possible time. Any insurer violating this Section shall pay the insured or claimant a penalty of two hundred dollars ($200) or fifteen percent (15%) of the face amount of the check or draft, whichever is higher.

\(^2\)\(^4\)\(^3\). Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940).