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Making Cashier's Checks and Other Bank Checks Cost-Effective: A Plea for Revision of Articles 3 and 4 of the Uniform Commercial Code

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I. INTRODUCTION

Promulgation of the Uniform Commercial Code[1] offered our nation's legal and business communities the hope of a system that would "simplify, clarify and modernize the law governing commercial transactions."[2] Article 9 of the Code, for example, is a lucid realization of this hope. In framing Article 9, the draftsmen abandoned a body of inconsistent, anachronistic laws governing security interests in personal property and, starting virtually from scratch, tailored a new system of priorities.[3] These priorities reflect the draftsmen's careful balancing of society's interest in commercial efficiency against their own interest in protecting the public from overreaching. In 1972, after observing the operation of these new rules for several years, the draftsmen revised Article 9 to comport more closely with the requirements of current commercial practice.[4] As a result

1. The Uniform Commercial Code will hereinafter be referred to either as the Code or as the U.C.C. Citations are to the 1978 Official Text of the U.C.C. The organizations that sponsor the writing and revision of the U.C.C. are the American Law Institute and the National Conference of Commissioners on Uniform State Laws.

2. U.C.C. § 1-102(2)(a). Another purpose of the U.C.C. is "to make uniform the law among the various jurisdictions." *Id.* § 1-102(2)(c).

3. Pre-U.C.C. security devices included pledges, chattel mortgages, conditional sales, trust receipts, factor's liens, and field warehousing. The terms, systems of priorities, and necessity for filing these devices varied widely among jurisdictions. Article 9 established one type of security interest with a uniform system of priorities. *See* J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 754-57 (1972).

4. In 1966, the Permanent Editorial Board (established by the American Law Institute and the National Conference of Commissioners on Uniform State Laws) submitted a report which pointed out that since the approval of Article 9 in 1952, there had been 337 nonuniform amendments. The Article 9 Review Committee, established in response to this report, worked on amending Article

of this extensive revision, businesses can now predict with certainty the consequences of different courses of action.

Article 3 of the Code governs commercial paper, and Article 4 controls the bank collection process. Their lack of clarity often makes the planning of commercial transactions difficult. Unfortunately, the draftsmen of the Code had no similar impetus to start from scratch in designing these provisions. Apparently, the draftsmen were of the opinion that the rules codified in the earlier Negotiable Instruments Law (N.I.L.)[5] worked well enough. Rather than attempting wholesale revision of the N.I.L., therefore, they sought merely to modify its language, resolving only those questions on which the courts had seriously differed.[6] Because the current provisions of Articles 3 and 4 more or less restate the traditional rules of commercial paper, they fail to accommodate the new or innovative uses of commercial paper required by our modern economy. Further compounding the inadequacy of Articles 3 and 4 is their frequent lack of coordination; this problem stems from the fact that the two articles were drafted by separate groups of scholars and businessmen.[7]

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9 until October 1970, when it submitted a report to the Editorial Board. A final report was sent to the sponsoring organizations in 1971, and Article 9, as amended, was approved and published in 1972. Since then, it has been enacted in twenty-one jurisdictions. *See Explanation to Revised Article 9 of the Uniform Commercial Code*, 3 UNIFORM COMMERCIAL CODE (U.L.A.) 3 (1979 Pamphlet).

5. The N.I.L., which first codified the law of negotiable instruments, was enacted between 1890 and 1937 by all 48 of the then-existing states, and by the territories of Alaska, Hawaii, and Puerto Rico. Although the purpose of the N.I.L. was to establish uniform law among the states, diverse judicial interpretations of its provisions destroyed any semblance of uniformity. The U.C.C. has now superseded the N.I.L. in all states. *See* Note, *Blocking Payment on a Certified, Cashier's, or Bank Check*, 73 MICH. L. REV. 424, 430 n.46 (1974).

6. Karl N. Llewellyn, Chief Reporter for the Uniform Commercial Code, pointed out that the revision of the N.I.L. was to a great degree one of form rather than substance. Article 3 "concisely states the better case law under the N.I.L., cures a few old blobs, and rounds out and clears up operating questions." Llewellyn, *Why We Need the Uniform Commercial Code*, 10 U. FLA. L. REV. 367, 380 (1957).

7. Each article was initially delegated to one or two draftsmen, who were consulted by different advisory groups. The principal draftsman for Article 3 was William L. Prosser, while the principal draftsman for Article 4 was Fairfax Leary, Jr. J. WHITE & R. SUMMERS, *supra* note 3, at 3. As drafts of each article were prepared, they were reviewed and revised by the central drafting staff and by various committees of the sponsoring organizations. *See* note 1 *supra*. Reviews were made on a section-by-section basis. It was not until 1949 that the articles were combined and reviewed as a code. By this time, some of the articles had already received votes of tentative approval by the sponsoring organizations. *See* Mentschikoff, *The Uniform Commercial Code: An Experiment in Democracy in Drafting*, 36 A.B.A.J. 419 (1950).

One of the major problems shared by both Articles 3 and 4 is their failure to establish separate rules for the various types of commercial paper.[8] This is most evident from the lack of specific provisions recognizing and treating bank checks. This Article analyzes the problems created by the application of current Code provisions to bank checks. It examines the need in our economy for a negotiable instrument that can serve as a cash substitute, and suggests that the Code be amended to ensure that at least one type of bank check—the cashier's check—be allowed to serve this role.

II. THE MODERN USE OF BANK CHECKS

A. THE ROLE OF BANK CHECKS

In our economy, there are essentially two classes of checks in general use. The first consists of ordinary personal checks, which are those drawn upon a bank by a person or entity other than a bank.[9] Banks are not liable on these checks unless they accept[10] or pay them.[11] The second class is comprised of cashier's, certified, and teller's checks, which collectively are known as bank checks. A cashier's check is a check drawn by a bank upon itself, a certified check is a personal check that a bank has accepted, and a teller's check is a check drawn by one bank—usually a savings and loan association—upon another bank.[12] Both personal and bank checks serve primarily as vehicles for transferring funds. They are intended to be used as means for making immediate payment, not as credit devices or evidence

8. Another deficiency of Article 3 is the absence of rules allocating the loss attributable to negligent behavior in commercial transactions. Under Article 3's negligence provisions, it is not clear whether contributory negligence is a defense, or what types of negligence preclude recovery and what circumstances are sufficient to justify such preclusion. *See* Farnsworth & Leary, *U.C.C. Brief No. 10: Forgery and Alteration of Checks*, 14 PRAC. LAW. 75 (Mar. 1968). Moreover, it is not clear whether U.C.C. § 3-406—the basic provision governing negligence—either provides a cause of action against a negligent drawer or protects the taker of paper bearing a forged indorsement. *See* Palizzi, *Forgeries and Double Forgeries Under Articles 3 and 4 of the UCC*, 42 S. CAL. L. REV. 659 (1969). In addition, Article 3 fails to clarify the right of an accommodation party to raise the accommodated party's defenses. *See* J. WHITE & R. SUMMERS, *supra* note 3, at 442-43; Peters, *Suretyship Under Article 3 of the Uniform Commercial Code*, 77 YALE L.J. 833 (1968).

9. U.C.C. § 3-104(2)(b).

10. *Id.* § 3-409(1).

11. *Id.* § 4-213(1).

12. Only the drawer bank is liable on a teller's check unless the drawee bank has accepted it. *Id.* § 3-409(1).

of indebtedness.[13] Their common advantage over cash is that they enable parties to transfer funds with less risk of theft or other loss.

Certain risks, however, prevent personal checks from serving as true cash substitutes. One risk is that a buyer of goods who pays by check may not have adequate funds to cover the check. This risk can be called the "risk of insolvency."[14] A second risk is that a buyer who pays by personal check may stop payment on the check, or may in some other way persuade the bank upon which the check is drawn to resist payment. The seller must then bring a lawsuit to recover the payment owed. This situation not only requires the seller to expend funds for litigation, but also deprives him of the use of funds during the pendency of the action. This risk can be termed the "risk of litigation."[15]

These risks give rise to a variety of costs. The costs absorbed by sellers who take bad checks are passed on to the public in the form of higher prices. Banks also bear certain costs associated with these risks; they must employ more clerks to handle the problems created by stop payment orders. In addition, should a bank fail to comply with a timely and proper stop order, it will suffer an additional loss if it is unable to recover the funds it paid to the holder. These extra costs to banks are reflected in higher prices for maintaining checking accounts. Despite these risks and accompanying costs, per-

13. In Bates-Crumley Chevrolet Co. v. Brown, 141 So. 436 (La. App. 1932), the court observed,

> There is a difference between a check and a promissory note. A check represents money and is merely the vehicle or means of delivery of the money. Whereas, a note is a written engagement or promise to pay a certain sum of money at a time specified. It is the evidence of an obligation to pay.

Id. at 439.

14. The risk of insolvency gives rise to a substantial cost. Whenever a seller does not receive payment for goods because of a buyer's insolvency, the cost of these goods must be absorbed into overhead and spread over the price of the remaining goods.

15. By paying with a check, the buyer may shift the burden of commencing an action to the holder without incurring any penalty for this imposition. Since our legal system does not tax the losing party with the attorney's fees of the prevailing party, the seller bears this expense even if successful. The shifting of these risks is a powerful weapon that often causes the buyer to obtain an undeserved favorable settlement. If a buyer has a legitimate reason for stopping payment on a check, however, the seller would probably still have had to incur these costs even if the buyer had paid cash, since the buyer would have sued the seller. But, if a buyer's basis for suit is questionable, he probably will not undertake the expense of commencing legal proceedings if he has already paid in cash.

sonal checks are widely used. Businesses generally accept personal checks, and most markets are elastic enough to permit the incremental raising of prices necessary to cover their costs.

Frequently, however, a seller who is particularly risk averse is unwilling to participate in a transaction involving payment by personal check. And, under certain circumstances, the market simply cannot bear the increased costs associated with the use of personal checks. For instance, a seller may not wish to assume the risk of litigation or of insolvency when a transaction involves the sale of real estate or of a business. Yet, for the same transaction, a buyer may not wish to assume the risk of theft or of other loss that accompanies the use of cash. Clearly, this situation calls for a viable cash substitute that mitigates these risks for both parties.

Two often-advanced possibilities, credit cards and electronic funds transfer systems, are inadequate for this purpose. Credit card companies assume certain transactional risks, but they charge sellers for the service. Sellers, in turn, pass on this charge to buyers in the form of higher prices.[16] Electronic funds transfer systems, however, are ideally suited to eliminating these risks. These systems simultaneously credit the seller's and debit the buyer's bank accounts.[17] Unfortunately, this method of transferring funds appears to be years away from nationwide implementation.[18]

16. *See* Cleveland, *Bank Credit Cards: Issuers, Merchants, and Users*, 90 BANKING L.J. 719 (1973). Credit card companies usually charge retailers between three and six percent of the amount of the purchase. Retailers must include the charge levied by credit card companies in their operating costs. *See* O'Driscoll, *The American Express Case: Public Good or Monopoly?*, 19 J.L. & ECON. 163 (1976). For a discussion of the mechanics of credit card use, see Comment, *The Applicability of the Law of Letters of Credit to Modern Bank Card Systems*, 18 U. KAN. L. REV. 871, 873-75 (1970).

17. For a more detailed explanation of electronic funds transfer systems, see J. WHITE, BANKING LAW—TEACHING MATERIALS 700-14 (1976).

18. The implementation of point of sale terminals (POSTs), one of the more sophisticated forms of electronic funds transfer systems (EFTs), appears to be years away not for technological reasons—the basic technology is already in place—but, rather, because of complex legal and economic problems. POSTs, operated in conjunction with automated clearing houses (ACHs), would handle all credit transactions between the participating merchants in a certain region and the banks that have joined together to supply that region's ACH. Although it was once proposed that EFTs generally be treated as electronic mailboxes, courts have begun to view EFT terminals operated by nationally chartered banks as branch offices subject to state branch banking regulations. Woodruff, *Electronic Funds Transfer in the Bank Card Industry*, 1977 WASH. U. L.Q. 501, 503-05. The Independent Bankers Association of America (IBAA)—a trade association whose membership is comprised of about fifty percent of the commercial banks in the United States—strongly opposes implementation of EFTs. The IBAA is made up of locally-owned rural and sub-

Bank checks, therefore, seem best able to serve as cash substitutes. Since the public already perceives bank checks as the equivalent of cash, there is no need to educate the public regarding their use. Moreover, the use of bank checks avoids the risk of theft or other loss inhering in the use of cash, and obviates the risk of insolvency that accompanies the use of personal checks, since there is little risk of a bank becoming insolvent.[19] And, even if a bank insolvency were to occur, most banks are covered by the Federal Deposit Insurance Corporation, which insures the full amount of most bank checks.[20]

Under the current provisions of Articles 3 and 4, however, the use of bank checks entails a serious risk of litigation. The provisions of the Code do not specifically address bank checks.[21] But the general provisions of the Code on negotiable instruments, if applied to transactions involving bank checks, appear to permit the assertion of a variety of claims to and defenses against them.[22] If a bank decides to utilize one or more

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urban banks, and excludes banks and corporations controlled by multi-bank holding companies. The goal of the IBAA is to increase government regulation of banking so that the operation of free competition does not result in the concentration of deposits in a few large national banks. *See* Peterson, *Electronic Funds Transfer and the Small Bank*, 1977 WASH. U. L.Q. 513, 513. A second problem with EFTs concerns their treatment under federal antitrust laws. The operators of ACHs, who will always be some combination of competing banks, may have to share the service with other competitors if it is the only system available. *Cf.* Associated Press v. United States, 326 U.S. 1 (1945) (news gathered by and distributed among Associated Press members cannot be withheld from nonmembers). The Justice Department, however, has advised the organizers of at least one EFT—which would have represented eighty percent of the deposits in the state of Nebraska—that the system may constitute a monopoly in violation of section 7 of the Clayton Act, 15 U.S.C. § 18 (1976). *See* Woodruff, *supra*, at 505. For a detailed examination of the antitrust implications raised by EFTs, see Ubell, *Electronic Funds Transfer and Antitrust Laws*, 93 BANKING L.J. 43, 51-81 (1976).

19. The number of bank failures has decreased dramatically since the Depression. Between 1930 and 1932, there were more than 5,100 bank failures, but between 1973 and 1975 there were only twenty-three. E. FARNSWORTH, CASES AND MATERIALS ON COMMERCIAL PAPER 235 (2d ed. 1976). *See also* J. WHITE, *supra* note 17, at 715.

20. The holders of certified, cashier's, and teller's checks are considered depositors of the bank and, therefore, are covered by FDIC insurance to a maximum amount of $40,000. 12 C.F.R. § 330.11 (1979).

21. The one exception is the Code's treatment of certified checks, which are specifically covered by several provisions, including U.C.C. §§ 3-410, 3-411, and 3-418. The Code's only reference to cashier's checks is in U.C.C. § 4-211(1)(b), *see* note 32 *infra*, and its only significant reference to teller's checks is in U.C.C. § 4-104(1)(e), which defines "customer" to include one bank carrying an account with another. This reference seems to indicate that teller's checks are to be treated similarly to ordinary personal checks except for the fact that the drawer is a bank.

22. *See* U.C.C. §§ 3-305, -306.

of these claims or defenses to resist payment on its own bank check, the check holder must commence a legal action for payment. This situation prevents bank checks from offering the finality of cash payments, and thus deprives them of their role as cost-effective cash substitutes.

Commentators discussing the rights of bank check obligors have focused mainly on the problem of determining when these obligors may resist payment under the provisions of the Uniform Commercial Code.[23] These commentators have failed, however, to examine the appropriate role of bank checks in our economy, and the question of whether treating them under the existing provisions of the Code strips them of their independent function as cash substitutes. Cashier's checks and certified checks are well suited to serve as cash substitutes. Given the business community's need for such an instrument, there is no reason why these checks should not be permitted to fill this role. Teller's checks, however, are probably better left to serve as the personal checks of banks.

The Code should therefore be amended to accommodate the appropriate role of cashier's and certified checks. The draftsmen should establish a comprehensive set of rules permitting no defenses against cashier's and certified checks other than forgery and alteration. Allowing only these defenses is necessary if these checks are to have any advantage over cash.[24] Permitting other defenses or claims unnecessarily imposes on the use of bank checks substantially the same costs that are inherent in the use of personal checks. It is the addi-

23. *See generally* 6D W. WILLIER & F. HART, BENDER'S UNIFORM COMMERCIAL CODE SERVICE § 4-403, at 2-1194 (1978); Benson, *Stop Payment of Cashier's Checks and Bank Drafts Under the Uniform Commercial Code*, 2 OHIO N. L. REV. 445 (1975); Fox, *Stopping Payment on a Cashier's Check*, 19 B.C. L. REV. 683 (1978); Wallach, *Negotiable Instruments: The Bank Customer's Ability to Prevent Payment on Various Forms of Checks*, 11 IND. L. REV. 579 (1978); Note, *Personal Money Orders and Teller's Checks: Mavericks Under the U.C.C.*, 67 COLUM. L. REV. 524 (1967); Note, *supra* note 5, at 424; Note, *Adverse Claims and the Consumer: Is Stop Payment Protection Available?*, 67 NW. U. L. REV. 915 (1973). *But see* Comment, *The Rights of a Remitter of a Negotiable Instrument*, 8 B.C. INDUS. & COM. L. REV. 260 (1967).

24. Although beyond the scope of this Article, it is an interesting question whether the U.C.C.'s allocation of the risk of loss for forgery and alteration, set forth in U.C.C. §§ 3-419, 3-406, 3-417, and 4-207, is consistent with the use of bank checks as cash equivalents. It is clear that these rules of allocation, which protect against the risks of loss and theft, provide bank checks with their principal advantage over cash. As a result of this protection, then, it seems that at least some of the risks associated with forgery and alteration should be assumed by holders of bank checks.

tion of these costs that makes bank checks inefficient substitutes for cash.

B. The Importance of Certainty

Bank checks can better serve as viable cash substitutes if the Code is amended to include provisions assuring them of that role. These new provisions could be either highly specific or open-ended and general. The costs that stem from the uncertainty concomitant with general rules, however, indicate that more specific provisions would best accommodate and promote the efficient use of bank checks as cash substitutes.

It is true that nonspecific rules of law are best able to provide equity in individual cases. They establish a flexible framework for resolving disputes on a case-by-case basis. This flexibility is important in areas such as tort law. The statutes and court decisions dealing with torts normally provide only general guidance for behavior, focusing instead on after-the-fact resolution of conflicts. This is partly because victim compensation has supplanted behavioral guidance as the primary goal of tort law.[25] Highly specific guidelines would therefore be superfluous, since the sorts of behavior now regulated by tort law are seldom the subject of detailed advance planning. In the area of commercial law, however, the need for unambiguous behavioral guidelines is much greater.[26] Businessmen plan commercial transactions with specificity and care. It is important that commercial laws set forth in detail the results certain to follow from different courses of conduct, so that transactional risks can be avoided or allocated at the planning stage.[27]

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25. *See generally* W. Prosser, Handbook on the Law of Torts 16-19 (4th ed. 1971).

26. For a contrary view of the importance of certainty in formulating rules of commercial law, see Jackson & Peters, *Quest for Uncertainty: A Proposal for Flexible Resolution of Inherent Conflicts Between Article 2 and Article 9 of the Uniform Commercial Code*, 87 Yale L.J. 907 (1978).

27. It is also important that the drafters of commercial laws consider the additional costs that are generated when a rule requires one party to assume certain risks for the protection of another party. The party assuming these risks usually passes on the cost to the other party. For example, Uniform Consumer Credit Code § 2-403 prohibits retailers from taking any negotiable instrument, other than a check, in a consumer credit sale or lease. This prohibition has been adopted in substance by eight states: Colorado, Idaho, Indiana, Kansas, Oklahoma, Utah, Wisconsin, and Wyoming. It protects consumers by negating the transfer of their notes to a holder in due course, thereby enabling consumers to raise their defenses no matter who has possession of the note. The inability of retailers to transfer such notes free of consumer defenses requires the holders to assume the risk of the retailer's breach of contract. Holders, therefore, will pay retailers less for such notes. This lower price in turn

It is also important that commercial laws assure businessmen that their bargained-for allocations of risk will be respected by courts.[28]

The uncertainty created by open-ended rules of law tilts the balance in favor of drafting highly specific Code amendments to govern bank checks. Detailed amendments would not only help businessmen intelligently plan transactions involving bank checks, but would also decrease the cost of these transactions. The savings, in turn, could be passed on at least in part to the consuming public. It is conceded that a highly specific set of rules would deprive courts of the opportunity to settle disputes on a case-by-case equitable basis. Moreover, the rigidity inherent in a system of specific rules would require that a certain amount of adaptability be sacrificed. A wisely drafted system of rules would, however, provide equity in the overwhelming majority of cases. Furthermore, adaptability is not necessarily desirable in this context;[29] the changing economic

causes retailers to raise the prices of their products so that they will obtain the same net price. Since this prohibition on taking negotiable instruments other than checks applies even where sophisticated buyers are involved, all consumers are required to pay for this added protection.

28. Also to be considered are the counterproductive costs generated by the uncertainty inherent in open-ended commercial laws. The costs of litigation and planning comprise the major portion of these increased costs. The behavior of finance companies that hold consumer notes illustrates these costs. U.C.C. § 3-302 provides that unless the holder of a note fails to meet certain requirements, he is a holder in due course and takes free of any claim or defense of the maker of the note. At least one court has held, however, that a finance company which has a close connection with the seller of consumer goods might not be a holder in due course, even if the finance company appears to meet all of the section 3-302 requirements. Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967). This judicial gloss on section 3-302 makes the rules of law relating to transactions involving consumer notes and finance companies very uncertain. Since the issue of holder in due course status, even when meritless, may be raised by a consumer, finance companies must take the risk of litigation into consideration when calculating the discount to be exacted from retailers when purchasing retailers' notes. This additional, unproductive cost is ultimately passed on to the consumer in the form of higher prices.

An uncertain rule, subject to a variety of plausible interpretations, offers an obligor some incentive for requiring his obligee to establish and enforce the obligation in court. Such a rule may offer false color to the obligor's position, and may be used to circumvent a motion for summary judgment, or to obtain a favorable settlement even when none is deserved. Businessmen consult attorneys at the planning stage of commercial transactions. The more uncertain the effects of a law are upon a particular transaction, the more time-consuming and costly will be the attorney's services. These added costs are ultimately passed on to the consuming public.

29. It has been suggested that the inadaptability of Articles 3 and 4 to electronic funds transfer systems is a fault of the positivist scheme of those articles. Jackson & Peters, *supra* note 26, at 908. This view, however, fails to take account of the fact that electronic funds transfer systems present such varied

realities brought about by novel systems of transferring funds may require totally new rules rather than piecemeal adjustments to existing rules.

This approach to drafting new Code provisions governing bank checks is consistent with the philosophy underlying Articles 3 and 4. Like its predecessor, the N.I.L., Article 3 was intended to establish a detailed set of rules defining rights and liabilities for the various types of negotiable instruments.[30] If the legal consequences of using a certain negotiable instrument in commercial transactions are not foreseeable, the free negotiability of that instrument will be seriously undermined. The Code, therefore, should provide clear and certain guidance to the users of bank checks. Until Articles 3 and 4 are amended, bank checks will remain inefficient cash substitutes.

III. CASHIER'S CHECKS

A. INTRODUCTION

A cashier's check is a negotiable instrument drawn by a bank upon itself.[31] The issuing bank is both drawer and drawee, and is primarily liable on the instrument. Occasionally a bank issues a cashier's check in satisfaction of a debt it owes to the check's payee. More often, though, a customer of the issuing bank purchases a cashier's check for its own use. Two separate transactions are usually involved in the latter case. First, the bank in effect sells the check to its customer. Then the customer, referred to as the purchaser, negotiates the check to a third party.

Although the common belief is that cashier's checks are cash equivalents, the provisions of the Uniform Commercial Code give no indication of how cashier's checks are to be treated.[32] The Code's failure to set forth the rights and liabili-

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problems and different needs for allocation of losses that any rule capable of covering both electronic funds transfer systems and conventional commercial paper would necessarily be so open-ended that it would be extremely cost-inefficient.

30. *See* Llewellyn, *supra* note 6, at 380.

31. Cashier's checks should not be confused with personal money orders. The two instruments are purchased for different reasons. Courts treat personal money orders as single-transaction personal checks; the purchaser is the drawer, and the bank is the drawee. The purchaser normally is a person who does not have a checking account, but who needs a check for the safe transfer of funds and for record-keeping purposes. *See* Note, *Personal Money Orders and Teller's Checks: Mavericks Under the UCC*, 67 COLUM. L. REV. 524, 524-39 (1967).

32. There is no explicit reference to cashier's checks in Article 3. The

ties of the parties to a cashier's check has created a good deal of confusion. Moreover, the concern voiced by those courts that seek to ensure the cash-like quality of cashier's checks[33] is at odds with the assumption that these checks should be governed by existing provisions of the Code.

The problem of allocating the risks of litigation and of lost funds has been especially vexing when either the bank or purchaser has a defense arising from the purchase of a cashier's check or from its subsequent negotiation. Courts and commentators have divided sharply over which parties most deserve protection. Two general approaches to the problem have developed. The first looks upon cashier's checks as ordinary negotiable instruments, and treats them as such under the Code.[34] The second approach looks upon cashier's checks as cash equivalents, and ignores the Code provisions that allow obligors on ordinary negotiable instruments to escape liability under certain conditions.[35]

1. *The Ordinary Negotiable Instrument Theory*

The majority of commentators and a minority of the courts[36] have adopted the first approach, viewing the bank's liability on a cashier's check as governed by Code sections 3-305[37]

Code's only reference to cashier's checks is in section 4-211(1), which enumerates the types of payment that collecting banks may take in settlement of an instrument for the payment of money.

33. *See* cases cited in note 155 *infra*.

34. *See* notes 36-46 *infra* and accompanying text.

35. *See* notes 47-50 *infra* and accompanying text.

36. Some of the courts taking this position view a cashier's check as a promissory note, while others view it as an accepted draft. Comment, *Commercial Paper: Taking a Bank Money Order "For Value" Under U.C.C. Section 3-303*, 63 MINN. L. REV. 983, 985-86 n.12 (1979). Under either approach, however, courts apply U.C.C. §§ 3-305 and 3-306 to determine the liability of banks. Most courts follow the pre-Code view that cashier's checks are bank drafts accepted by the act of issuance. *See, e.g.*, Swiss Credit Bank v. Virginia Nat'l Bank, 538 F.2d 587 (4th Cir. 1976); Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620 (7th Cir. 1973); Pennsylvania v. Curtiss Nat'l Bank, 427 F.2d 395 (5th Cir. 1970); Bank of Niles v. American State Bank, 14 Ill. App. 3d 729, 303 N.E.2d 186 (1973). *See also* Fox, *supra* note 23, at 690 n.55; Wallach, *supra* note 23, at 587 n.36; Note, *supra* note 5, at 427 n.25. A minority of courts, however, have adopted the view that cashier's checks should be treated as promissory notes. *See, e.g.*, TPO Inc. v. FDIC, 487 F.2d 131 (3d Cir. 1973); Banco Ganadero y Agricola v. Society Nat'l Bank, 418 F. Supp. 520 (N.D. Ohio 1976); Laurel Bank & Trust Co. v. City Nat'l Bank, 33 Conn. Supp. 641, 365 A.2d 1222 (Super. Ct. 1976); Wilmington Trust Co. v. Delaware Auto Sales, 271 A.2d 41 (Del. 1970); State Bank v. American Nat'l Bank, 266 N.W.2d 496 (Minn. 1978); Thompson Poultry, Inc. v. First Nat'l Bank, 199 Neb. 8, 255 N.W.2d 856 (1977). *See generally* 6D W. WILLIER & F. HART, *supra* note 23, § 4-403, at 2-1194.

37. U.C.C. § 3-305 provides:

and 3-306.[38] These are the provisions applicable to obligors on notes and ordinary personal checks. Although in agreement on the particular Code provisions that determine liability, the proponents of this view are nevertheless split over the precise nature of cashier's checks. One group considers the instrument similar to a promissory note,[39] viewing the bank as the note's maker. This group draws support from section 3-118(a),[40] which provides that a draft drawn on a drawer is to be treated as a note. The other group considers a cashier's check similar to a draft of the issuing bank that the bank has accepted by the act of issuance.[41] Despite this conspicuous difference, the second group believes that the practical import of characterizing cashier's checks as accepted drafts rather than as notes is insignificant, because section 3-413(1) provides that the contracts

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To the extent that a holder is a holder in due course he takes the instrument free from
(1) all claims to it on the part of any person; and
(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
(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.

38. U.C.C. § 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); 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.

39. *See* note 36 *supra*.

40. U.C.C. § 3-118 provides, in part, that "[t]he following rules apply to every instrument: (a) Where there is doubt whether the instrument is a draft or a note the holder may treat it as either. A draft drawn on the drawer is effective as a note."

41. *See* note 36 *supra*.

of acceptors and of makers are identical.[42] Assuming therefore that the contract of an issuing bank is the same under either of these views, the second group concludes that a bank's liability on cashier's checks should be governed by sections 3-305 and 3-306, just as if the check were a note.

Although seductive, the reasoning of both groups is flawed. Section 3-118(a) was intended simply to eliminate the need for a holder of a note or accepted draft to protest or give notice of dishonor to the instrument's maker or acceptor.[43] The draftsmen of the Code recognized that requiring these parties to protest or give notice of dishonor would serve no function, since presumably they should already be aware of their own refusal to pay. Section 3-413(1) was designed to deal with the effect of alteration, and to set out the procedural conditions precedent to the liability of the instrument's acceptor or maker.[44] Neither sections 3-118(a) nor 3-413(1) were drafted with the aim of specifying the defenses available to obligors. In fact, under the Code, it is clear that acceptors and makers have different obligations. Sections 3-305 and 3-306 govern the liability of a maker of a note, while section 3-418[45] expressly controls the liability of an acceptor of a draft.[46] Nearly all courts and commentators, however, have overlooked this distinction.

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42. U.C.C. § 3-413(1) provides: "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."

43. U.C.C. § 3-118(a), which essentially adopts the position taken by N.I.L. § 130, was intended to give the holder of a cashier's check, or of any other draft drawn on the drawer, the procedural advantages that accrue to the holder of a promissory note. These advantages include eliminating the need that the holder present the instrument for payment or give notice of dishonor as a condition precedent to the liability of the draft's drawer. *See* W. BRITTON, HANDBOOK OF THE LAW OF BILLS AND NOTES § 187, at 528 (2d ed. 1961); *id.* § 221, at 576.

44. At common law, an acceptor engaged to pay the instrument according to its original tenor. Because of the ambiguous language of N.I.L. § 62, a split later developed among the courts on this point, with some holding instead that the acceptor engaged to pay the instrument according to its tenor at the time of the acceptance. *See* W. BRITTON, *supra* note 43, § 140, at 399. *See also* U.C.C. § 3-413, Official Comment.

45. U.C.C. § 3-418 provides:

> Except for recovery of bank payments as provided in the Article on Bank Deposits and Collections (Article 4) 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.

46. *See* U.C.C. § 3-413, Official Comment.

2. *The Cash-Substitute Theory*

The majority of courts passing on the question of a bank's liability on its own cashier's checks have adopted the second approach, treating cashier's checks as almost equivalent to cash.[47] Most of these courts have taken the position that a cashier's check is an accepted draft, but have ignored sections 3-305, 3-306, and 3-418 in determining the liability of the issuing bank. Instead, they have imposed an absolute obligation on the issuing banks, prohibiting them from raising any defenses to payment, even against holders who are not holders in due course. In *National Newark & Essex Bank v. Giordano*,[48] the court explained the reason for subordinating the interests of the bank and the check's purchaser to the holder's expectation that he has received a true cash equivalent:

> A cashier's check circulates in the commercial world as the equivalent of cash . . . . People accept a cashier's check as a substitute for cash because the bank stands behind it, rather than an individual. In effect the bank becomes a guarantor of the value of the check and pledges its resources to the payment of the amount represented upon presentation. To allow the bank to stop payment on such an instrument would be inconsistent with the representation it makes in issuing the check. Such a rule would undermine the public confidence in the bank and its checks and thereby deprive the cashier's check of the essential incident which makes it useful. People would no longer be willing to accept it as a substitute for cash if they could not be sure that there would be no difficulty in converting it into cash.[49]

One problem with the approach taken in *National Newark* is that no Code provisions support it. As a result, courts following *National Newark* have often relied upon inapplicable Code provisions which only superficially support their judgments regarding the cash-like nature of cashier's checks.[50]

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47. *See, e.g., In re* Johnson, 552 F.2d 1072, 1078 (4th Cir. 1977); Swiss Credit Bank v. Virginia Nat'l Bank, 538 F.2d 587, 588 (4th Cir. 1976); Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620, 624 (7th Cir. 1973); Kaufman v. Chase Manhattan Bank, 370 F. Supp. 276, 278 (S.D.N.Y. 1973); State *ex rel.* Chan Siew Lai v. Powell, 536 S.W.2d 14, 16 (Mo. 1976); National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 350, 268 A.2d 327, 329 (1970); Tranarg v. Banca Commerciale Italiana, 90 Misc. 2d 829, 835-36, 396 N.Y.S.2d 761, 764 (Sup. Ct. 1977); Moon Over the Mountain, Ltd. v. Marine Midland Bank, 87 Misc. 2d 918, 920, 386 N.Y.S.2d 974, 975 (Civ. Ct. N.Y. 1976); Wertz v. Richardson Heights Bank & Trust, 495 S.W.2d 572, 574 (Tex. 1973).

48. 111 N.J. Super. 347, 268 A.2d 327 (1970).

49. *Id.* at 351-52, 268 A.2d at 329.

50. Since a stop payment order may not be issued against an accepted instrument, *see* U.C.C. § 4-303(1)(a), several courts have prohibited banks from raising any defense against cashier's checks. *See* Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620 (7th Cir. 1973); Kaufman v. Chase Manhattan Bank, 370 F. Supp. 276 (S.D.N.Y. 1973); State *ex rel.* Chan Siew Lai v. Powell, 536 S.W.2d 14 (Mo. 1976); National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 268 A.2d 327 (1970); Wertz v. Richardson Heights Bank & Trust, 495

Neither of these approaches—the ordinary negotiable instruments theory or the cash-substitute theory—is satisfactory. Cashier's checks deserve special treatment because of their distinctive role as a cash substitute, and the courts that treat cashier's checks under the provisions of the Code governing ordinary checks and notes fail to accommodate this unique role. On the other hand, the courts that accord cashier's checks cash-equivalent status by misapplying the Code diminish the Code's utility as a guide for commercial planning. The situation can be corrected only by amending the Code to specifically define the nature of liability on cashier's checks.

B. The Current Treatment of Cashier's Checks

Before discussing the Code amendments needed to promote a more cost-efficient role for cashier's checks, it would be helpful to examine more fully the current rights and liabilities of parties to cashier's checks. This examination will focus on the rules governing the claims and defenses that may be raised by banks which are resisting payment, because it is these rules that provide the greatest potential for diluting the role of cashier's checks as cash substitutes.

1. *The Appropriate Terminology*

When some irregularity surrounding the issuance or negotiation of a cashier's check has occurred, the purchaser or the issuing bank itself may desire that payment be resisted. These situations often raise the issue of whether a purchaser or a bank may have payment stopped. The term "stop payment," however, has no application either to a bank's right to refuse payment or to a purchaser's ability to compel a bank to refuse payment.[51] The use of this term only confuses the real issue: whether a bank's obligation to pay a cashier's check may be nullified by the interposition of either the purchaser's or the bank's own claims or defenses.

The purchaser of a cashier's check has no right to order the bank to stop payment on the check.[52] This is clear from section

S.W.2d 572 (Tex. 1973). One court, however, relied upon U.C.C. § 3-802. *See* Moon Over the Mountain, Ltd. v. Marine Midland Bank, 87 Misc. 2d 918, 386 N.Y.S.2d 974 (Civ. Ct. N.Y. 1976); text accompanying notes 161-164 *infra*.

51. *See* Wertz v. Richardson Heights Bank & Trust, 495 S.W.2d 572, 575 (Tex. 1973) (Walker, J., dissenting).

52. Pennsylvania v. Curtiss Nat'l Bank, 427 F.2d 395, 399 (5th Cir. 1970); National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 268 A.2d 327 (1970); Dziurak v. Chase Manhattan Bank, 58 A.D.2d 103, 106, 396 N.Y.S.2d 414,

4-403(1),[53] which permits a person to stop payment only on an instrument "payable for his account."[54] Whether considered a note or an accepted draft, a cashier's check is payable for the account of the issuing bank, not the check's purchaser. An alternative analysis, which applies only if a cashier's check is considered an accepted draft, leads to the same conclusion based on section 4-303(1)(a).[55] This section provides that a stop payment order on a negotiable instrument comes too late if given subsequent to acceptance.

A purchaser may attempt to accomplish a result similar to stopping payment by asserting an adverse claim to a cashier's check.[56] The right of a purchaser to assert such a claim, however, appears doubtful.[57] Moreover, the procedural limitations

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415-16 (1977), *aff'd*, 44 N.Y.2d 776, 377 N.E.2d 474, 406 N.Y.S.2d 30 (1978). Prior to enactment of the U.C.C., some courts did permit a purchaser to stop payment on a cashier's check. *See* Nielsen v. Planters Trust & Sav. Bank, 183 La. 645, 647, 164 So. 613, 615-16 (1935); Wolf v. Title Guar. & Trust Co., 251 A.D. 354, 356, 296 N.Y.S. 800, 802-03 (1937), *aff'd*, 277 N.Y. 626, 14 N.E.2d 193 (1938); Drinkall v. Movius State Bank, 11 N.D. 10, 12, 88 N.W. 724, 726 (1901); Preston v. First State Bank, 344 S.W.2d 724 (Tex. Civ. App. 1961).

53. U.C.C. § 4-403(1) provides:

> A customer may by order to his bank stop payment of any item payable for his account but the order must be received at such time and in such manner as to afford the bank a reasonable opportunity to act on it prior to any action by the bank with respect to the item described in Section 4-303.

54. The rationale for this limitation is expressed in U.C.C. § 4-403, Official Comment 5:

> There is no right to stop payment after certification of a check or other acceptance of a draft, and this is true no matter who procures the certification. See Sections 3-411 and 4-303. The acceptance is the drawee's own engagement to pay, and he is not required to impair his credit by refusing payment for the convenience of the drawer.

55. U.C.C. § 4-303(1) provides, in part:

> Any knowledge, notice or stop-order received by, legal process served upon or setoff exercised by a payor bank, whether or not effective under other rules of law to terminate, suspend or modify the bank's right or duty to pay an item or to charge its customer's account for the item, comes too late to so terminate, suspend or modify such right or duty if the knowledge, notice, stop-order or legal process is received or served and a reasonable time for the bank to act thereon expires or the setoff is exercised after the bank has done any of the following:
>
> (a) accepted or certified the item . . . .

56. The right to assert an adverse claim is governed by U.C.C. § 3-603(1) which provides, in part:

> The liability of any party is discharged to the extent of his payment or satisfaction to the holder even though it is made with knowledge of a claim of another person to the instrument unless prior to such payment or satisfaction the person making the claim either supplies indemnity deemed adequate by the party seeking the discharge or enjoins payment or satisfaction by order of a court of competent jurisdiction in an action in which the adverse claimant and the holder are parties.

57. *See* notes 154-169 *infra* and accompanying text.

on asserting adverse claims make this approach far less effective than the analogous right of a drawer to stop payment on his personal checks.[58] In rare instances, a purchaser may persuade the issuing bank to refuse payment on a cashier's check, or the bank may refuse payment out of its own self-interest when it has a defense arising out of the issuance of the check. The term stopping payment is equally inappropriate for describing these situations.[59]

2. *The Bank's Ability to Raise Its Own Defenses*

When a bank has issued a cashier's check by mistake, or the consideration given for the check has failed,[60] the bank may refuse payment on the check. This forces the holder to bring a lawsuit establishing his right to payment. Whether a bank pursues this option depends on the bank's ability under the Code to advance its own defenses against the check.

In considering the circumstances under which a bank can defend against an action for payment on a cashier's check, it is important first to determine whether the holder of the check has dealt with the bank. When the purchaser of the check retains it, the bank, of course, has dealt with the holder. This situation significantly increases a bank's ability to successfully resist payment. Because of the liberal joinder of claims rules

58. In order to assert an adverse claim, the claimant must either supply indemnity for the obligor or obtain an injunction by a court having jurisdiction over both the obligor and holder. U.C.C. § 3-603(1). Issuance of a stop payment order, however, merely requires that the customer give notice to his bank "at such time and in such manner as to afford the bank a reasonable opportunity to act on it prior to any action by the bank with respect to the item described in Section 4-303." U.C.C. § 4-403(1).

59. The concept of stopping payment has relevance only to relations between a bank and its customer, the check's drawer. Since a personal check is simply an order to pay, a customer has the right to revoke the order before it is carried out. *See* Hawkland, *Stop Payment Orders Under the Uniform Commercial Code*, 75 COM. L.J. 53 (1970). Since the bank, as both drawer and drawee, is its own customer when it issues a cashier's check, it is nonsensical to speak of the bank's liability to itself for failing to stop payment on a cashier's check. Although it is obvious that the bank has the power to refuse to pay the check upon presentment, the real question is whether the bank has any legal basis for defeating the holder's subsequent action for payment.

60. In the following cases the issuing bank took a personal check drawn on insufficient funds in return for its cashier's check: Banco Ganadero y Agricola v. Society Nat'l Bank, 418 F. Supp. 520 (N.D. Ohio 1976); Kaufman v. Chase Manhattan Bank, 370 F. Supp. 276 (S.D.N.Y. 1973); Laurel Bank & Trust Co. v. City Nat'l Bank, 33 Conn. Supp. 641, 365 A.2d 1222 (Super. Ct. 1976). There also are cases where a bank took a forged check in payment for its cashier's check. *E.g.*, Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620 (7th Cir. 1973) (forged certification); Bank of Niles v. American State Bank, 14 Ill. App. 3d 729, 303 N.E.2d 186 (1973).

followed in most jurisdictions, a bank that has grounds for a defense arising out of the transaction in which the holder purchased the check may raise these grounds in the form of a counterclaim against the holder, regardless of whether the Code recognizes the grounds as a valid defense to a bank's obligation.[61] For example, if a holder purchased a cashier's check with a personal check drawn on insufficient funds, the bank could raise the holder's liability on his personal check as a counterclaim in the holder's action for payment on the cashier's check.

Typically, though, the purchaser of a cashier's check acquires the instrument from a bank for the purpose of negotiating it to a third party. In these cases, the issuing bank will not have dealt with the check's ultimate holder. Although the bank may have a complaint stemming from its issuance of the cashier's check to the purchaser, the bank is unable to raise this complaint as a counterclaim. The bank's ability to defeat the holder's action, therefore, depends upon whether the Code permits obligors to assert complaints, such as failure of the purchaser's consideration, as defenses to their obligations on cashier's checks.

The Code apparently recognizes this procedural distinction in the provisions that relate to ordinary personal checks and drafts—sections 3-305 and 3-306—which permit the assertion of defenses only against holders in due course with whom the obligor has dealt[62] and holders who are not holders in due course.[63] Section 3-306, however, which permits obligors to assert defenses against certain holders with whom the obligor has not dealt, evinces a value judgment that in certain situations society's interest in negotiability should give way to the interests of the obligor. It is not clear that the draftsmen of the Code ever contemplated the application of these provisions to cashier's checks, since these provisions certainly weaken the role of cashier's checks as cash substitutes. It is perhaps for this reason that many courts dealing with cashier's checks have ignored these provisions and found support for their positions elsewhere.[64] Because there are significant differences between

61. In most jurisdictions, a defendant may assert any claim he has against the plaintiff as a permissive counterclaim. *See, e.g.*, FED. R. CIV. P. 13; CAL. CIV. PROC. CODE § 428.10 (West 1973); ILL. ANN. STAT. ch. 110, § 38(1) (Smith-Hurd 1976); MINN. R. CIV. P. 13.02.

62. U.C.C. § 3-305(2).

63. *Id.* § 3-306(b), (c).

64. *See* note 50 *supra* and accompanying text.

a bank's ability to defend against its obligation on its cashier's checks when it has dealt with the holder and when it has not, the two situations are considered separately.

a. Defenses Available When the Bank Has Dealt with the Holder

A person who has purchased a cashier's check will not necessarily negotiate it to a third party. He may instead present it, through his own depositary bank, to the issuing bank for payment. The purchaser may have obtained a cashier's check in lieu of cash as final payment for a personal check drawn on the issuing bank. Or, he may have taken the check in payment for services rendered or goods furnished to the bank. Finally, a purchaser may have intended to use a cashier's check in a business transaction, but prior to negotiating it, may have become aware that the bank would raise defenses against it.

When such a purchaser sues to compel payment of a cashier's check, the bank is permitted to raise any defense or counterclaim it has against the purchaser.[65] This ability derives simply from a desire to effect the resolution of all disputes between the parties in a single action, that is, to avoid a multiplicity of suits. Courts and commentators have used conflicting rationales to justify this result. The apparent majority of commentators, discussing the question of when a bank may raise its own defenses against the holder of a cashier's check with whom the bank has dealt, have looked to sections 3-305 and 3-306[66] because no other provisions of the Code seem to govern an obligor's ability to raise its own defenses. These sections permit an obligor on an ordinary negotiable instrument to assert any defense against a holder with whom it has dealt, even when the holder has the status of a holder in due course.

Two courts have applied this analysis.[67] *Wilmington Trust Co. v. Delaware Auto Sales*[68] involved a situation in which a person had purchased a car with a personal check and then or-

65. *See* U.C.C. § 3-305(2); note 61 *supra*.

66. *See* 6D W. WILLIER & F. HART, *supra* note 23, § 4-403, at 2-1194. Benson, *supra* note 23, at 450; Wallach, *supra* note 23, at 590-91; Note, *Adverse Claims and the Consumer: Is Stop Payment Protection Available?, supra* note 23, at 919-20.

67. TPO Inc. v. FDIC, 487 F.2d 131 (3d Cir. 1973); Wilmington Trust Co. v. Delaware Auto Sales, 271 A.2d 41 (Del. 1970). Pre-U.C.C. cases that have applied analogous rules include Citizens Bank v. National Bank of Commerce, 334 F.2d 257 (10th Cir. 1964) and Tropicana Pools, Inc. v. First Nat'l Bank, 206 So.2d 48 (Fla. 1968).

68. 271 A.2d 41 (Del. 1970).

dered payment stopped on the check. The bank mistakenly failed to comply with the stop payment order and paid the auto dealer by issuing a cashier's check. After discovering its error, the bank refused to honor the cashier's check. The court held that, under section 3-305(2), the bank could raise the defense of failure of consideration against the check's holder, since the bank had dealt with the holder.[69] In the case of *TPO Inc. v. FDIC*,[70] the court held that the payee of a cashier's check, who had assisted in fraudulently inducing the bank to issue the check, was subject to the bank's defense of fraud under sections 3-306(b) and (c).[71]

The *Wilmington Trust* and *TPO* cases were decided by courts that treat cashier's checks as promissory notes. Most courts, however, view cashier's checks not as promissory notes, but as accepted drafts.[72] Under this view, section 3-418 governs the bank's ability to raise its own defenses against its obligation to pay.[73] The dissent in *Wertz v. Richardson Heights Bank & Trust*,[74] a case which also involved a bank mistakenly issuing a cashier's check as payment to the holder of a personal check

69. *Id.* at 42. One problem with the court's analysis is its finding that there was a failure of consideration for the cashier's check. The court reasoned that consideration had failed since the bank was unable to debit its customer's account after the bank had mistakenly violated his stop payment order. The court failed to consider that under U.C.C. § 3-418 the bank's payment of a personal check over a timely stop payment order constitutes final payment as to the holder. Since the holder in *Wilmington Trust* was entitled to the funds mistakenly paid to him by the bank, he gave the bank sufficient consideration for the cashier's check by relinquishing this claim. *See* Banco Ganadero y Agricola v. Society Nat'l Bank, 418 F. Supp. 520, 524, 526 (N.D. Ohio 1976); Citizens & S. Nat'l Bank v. Youngblood, 135 Ga. App. 638, 640, 219 S.E.2d 172, 174 (1975). The *Wilmington Trust* court should have found that there was adequate consideration for the cashier's check, and then permitted the bank to raise as a counterclaim the customer's cause of action against the holder to which the bank was subrogated. *See* U.C.C. § 4-407(c) (permitting bank that has paid over timely stop payment order to be subrogated to rights of the drawer as against the holder).

70. 487 F.2d 131 (3d Cir. 1973).

71. *Id.* at 136. The rationale of *TPO* was followed in the recent case of State Bank v. American Nat'l Bank, 266 N.W.2d 496 (Minn. 1978). *State Bank*, however, did not involve a situation where the holder had dealt with the bank.

72. *See* notes 36 *supra*; text accompanying note 47 *supra*.

73. A certified check is a draft that has been accepted by the drawee bank, and the right of a bank to rescind its certification is governed by U.C.C. § 3-418. *See* Admiral Leather Corp. v. Manchester Modes, Inc., 422 F. Supp. 387 (S.D.N.Y. 1976); Rockland Trust Co. v. South Shore Nat'l Bank, 366 Mass. 74, 314 N.E.2d 438 (1974); Balducci v. Merchants Nat'l Bank, 74 Misc. 2d 406, 345 N.Y.S.2d 263 (Sup. Ct. 1972), *aff'd*, 41 A.D.2d 1030, 344 N.Y.S.2d 828 (1973). Thus, if a cashier's check is regarded as an accepted draft, it follows that it also should be governed by section 3-418.

74. 495 S.W.2d 572 (Tex. 1973).

upon which payment had been stopped, adopted this view. The majority in *Wertz* had refused to permit the bank to assert the defense of failure of consideration, reasoning simply that a bank cannot stop payment on its own cashier's check.[75] The dissent correctly pointed out that the issue did not turn on the bank's ability to stop payment, but on its capacity to raise failure of consideration as a defense. The dissent argued that under the Code, acceptance of a draft should be treated just like its analogue: final payment. It therefore concluded that the bank should be capable of refusing to pay a cashier's check under circumstances in which it could have recovered monies paid by mistake had the draft been finally paid rather than accepted.[76]

Under section 3-418, a bank may resist payment of an accepted instrument unless the holder is a holder in due course, or has in good faith and in reliance on payment changed his position. Despite its dissimilarity, however, section 3-418 does not lead to a result different from sections 3-305 and 3-306 in situations where the holder has dealt with the bank. Under section 3-418, even if acceptance is final, the bank can raise its complaint against a holder with whom it has dealt as a counterclaim rather than as a defense.[77]

A number of courts steadfastly adhere to the concept that cashier's checks are cash substitutes,[78] and have flatly refused to allow an issuing bank to raise even those defenses arising from transactions with the check's holder.[79] These courts have also recognized, however, that when a bank has dealt with the holder, the bank may achieve the same result by filing a counterclaim under the local rules of civil procedure.[80] For instance,

75. *Id.* at 574.

76. *Id.* at 576 (Walker, J., dissenting).

77. The bank in *Wertz* was subrogated to the rights of the drawer of the personal check upon which payment had been stopped. If there had been a legitimate claim against the holder of the cashier's check, the bank could have asserted it as a counterclaim in the holder's action for payment. *See* U.C.C. § 4-407.

78. *See, e.g., In re* Johnson, 552 F.2d 1072 (4th Cir. 1977); Swiss Credit Bank v. Virginia Nat'l Bank, 538 F.2d 587 (4th Cir. 1976); Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620 (7th Cir. 1973); Kaufman v. Chase Manhattan Bank, 370 F. Supp. 276 (S.D.N.Y. 1973); Wertz v. Richardson Heights Bank & Trust, 95 S.W.2d 572 (Tex. 1973).

79. *See, e.g., In re* Johnson, 552 F.2d 1072 (4th Cir. 1977); Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620 (7th Cir. 1973); Wertz v. Richardson Heights Bank & Trust, 495 S.W.2d 572 (Tex. 1973).

80. *See In re* Johnson, 522 F.2d 1072 (4th Cir. 1977); Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620 (7th Cir. 1973).

in *Munson v. American National Bank & Trust Co.*,[81] a bank issued a cashier's check in exchange for another bank's certified check. The certification was a forgery, and the check was subsequently dishonored by the drawee bank. The bank that had issued the cashier's check raised this failure of consideration as a defense to its obligation on the cashier's check. The *Munson* court, expressly disapproving the *Wilmington* reasoning,[82] held that the issuing bank was absolutely foreclosed from raising any defense against the cashier's check.[83] The *Munson* court did, however, permit the bank to assert as a counterclaim the holder's breach of warranty on the certified check.[84]

If cashier's checks are to serve as cash substitutes,[85] it is essential that banks be denied the ability to raise defenses against holders with whom they have dealt. By demanding a cashier's check, the holder has bargained to shift to the issuing bank the risk of litigation and the accompanying loss of the use of funds. Allowing a bank to raise defenses in an action for payment on a cashier's check nullifies this bargained-for shifting of risks. If the bank had paid the holder in cash, or if the holder had already cashed the cashier's check, the bank would have the burden of commencing legal proceedings to resolve any problem and the holder would retain the use of his funds during the pendency of the suit. Ideally, a bank should be compelled to pay the holder of a cashier's check upon presentment, and then sue the holder in a separate action. The injustice that may result by requiring a bank to pay the check, although it may have grounds for complaint against the holder, is a risk that banks must assume when they issue cashier's checks.

Similarly, banks should not be permitted to escape pay-

81. 484 F.2d 620 (7th Cir. 1973).

82. *Id.* at 624 n.8.

83. *Id.* at 624.

84. *Id.* The court characterized the counterclaims as offsetting defenses.

85. Concededly, there are times when banks issue cashier's checks that their holders will not consider cash equivalents. This may occur when a bank uses a cashier's check to pay for goods or services furnished by the holder. The holder would not expect to recover on the check if the bank had a defense arising from the holder's failure to perform properly. It would be virtually impossible, however, to apply separate rules depending on whether or not the purchasers expected to receive a cash substitute. Some courts have taken the situation where a bank has dealt with a holder to indicate that the cashier's check was not intended to serve as a cash substitute. *See* cases cited in note 67 *supra*. This perception, however, is clearly incorrect. Often, the holder of a personal check who presents it for final payment prefers to take a cashier's check instead of cash to alleviate the risk of loss. If these holders were aware that the bank could assert a defense to its obligation on the cashier's check, they would certainly have required payment in cash.

ment on their cashier's checks simply by counterclaiming against the holder. Unfortunately, most jurisdictions have not established procedures requiring issuing banks to pay the holders of cashier's checks prior to adjudication of the bank's counterclaims.[86] One state, New York, has recognized the need to provide swift determination of the obligor's liability on negotiable instruments, and permits a holder to file a motion for summary judgment in lieu of filing a complaint.[87] In the summary judgment proceeding, the obligor may raise defenses to his obligation to pay, but not unrelated counterclaims. In other jurisdictions, however, the ordinarily liberal rules of joinder have not been modified to accommodate the peculiar sets of interests involved in negotiable instruments transactions. This weakness is especially apparent with respect to cashier's checks, where the policy of promoting judicial economy that underlies the rules of joinder works to erode the primary function of these instruments by making them less freely convertible into cash. Until this inadequacy of the Code is corrected,

86. Since most jurisdictions have no special procedural rules governing actions on negotiable instruments, the ordinary rules regarding permissive counterclaims are applied. Thus, if a bank's counterclaim is found to raise a genuine issue of fact, courts will protect the bank just as they would any other defendant, either by denying the plaintiff's motion for summary judgment or by granting the motion but staying execution pending the outcome of the counterclaim. *See* Taylor v. Rederi A/S Volo, 374 F.2d 545 (3d Cir. 1967); Luders v. Pummer, 152 Cal. App. 2d 276, 313 P.2d 38 (1957); Farm Serv. Co. v. Askeland, 169 N.W.2d 559 (Iowa 1969); Chelsea Exch. Bank v. Munoz, 202 A.D. 702, 195 N.Y.S. 484 (1922); Reiniger Plumbing & Heating, Inc. v. General Motors Corp., 25 Ohio App. 2d 25, 266 N.E.2d 257 (1970).

87. N.Y. CIV. PRAC. LAW § 3213 (McKinney 1970) provides that instead of commencing an action by the usual method of summons and complaint, a plaintiff may accompany the summons with motion papers for summary judgment. The summons requires the defendant to serve opposing papers, and to appear for the motion on a date specified in the motion papers. If the motion is denied, the moving and answering papers serve as the complaint and answer, respectively, unless the court orders otherwise. The purpose of the section is to afford quick resolution of actions on negotiable instruments, since these actions carry a strong presumption of merit and should not be subject to the same cumbersome treatment as other actions. In the absence of exceptional circumstances, therefore, it would be inconsistent with this purpose to permit a plaintiff's claim to be held up by the litigation of unrelated counterclaims. Normally, the court will sever an unrelated counterclaim and order a separate trial. *See* Mike Nasti Sand Co. v. Almar Landscaping Corp., 57 Misc. 2d 550, 293 N.Y.S.2d 220 (Sup. Ct. 1968), *rev'd on other grounds*, 34 A.D.2d 554, 309 N.Y.S.2d 697 (1970); Wildeb Rest., Inc. v. Jolin Restaurant, Inc., 69 Misc. 2d 1012, 331 N.Y.S.2d 575 (Civ. Ct. N.Y. 1972). *See* N.Y. CIV. PRAC. LAW § 3213 (McKinney 1970) (*Practice Commentaries* C 3213:17). It is not clear whether a counterclaim against a cashier's check holder based, for instance, on the bank's right of subrogation under U.C.C. § 4-407, is an unrelated counterclaim. If the New York procedure is to enhance the cash equivalency of cashier's checks, such counterclaims must be considered unrelated.

banks may continue to cause unnecessary transactional inefficiency by raising defenses to their obligations on cashier's checks under the terminology of counterclaim.

b. Defenses Available When the Bank Has Not Dealt with the Holder

When the purchaser of a cashier's check has transferred the check to a third party, the bank can no longer resist payment by raising counterclaims that stem from the issuance of the check.[88] This is because the third-party holder cannot be made liable for the debts of the purchaser. The only question in this situation, then, is whether the bank may raise its complaints against the purchaser as defenses in an action for payment by the holder of the check. Courts generally have allowed banks faced with this problem to litigate their own defenses to payment.[89] Relatively few of the courts deciding this issue, however, have taken account of the peculiar set of interests inhering in the use of cashier's checks.[90] Several courts have ignored these interests entirely, and have simply resolved the dispute as if it concerned a conflict between a holder of and an obligor on an ordinary note or personal check.[91]

There is a substantial body of authority which takes the position that sections 3-305 and 3-306 govern the ability of a bank to raise its own defenses when a third-party holder is involved.[92] Under this theory, the bank's ability to successfully resist payment by asserting its own defenses depends solely

88. Of course, if the transfer of the check from the purchaser to the holder involved a fraud upon the bank, the holder would be liable to the bank, under the laws of fraudulent conveyance, for the amount of the check. If the purchaser transfers the check to the holder for inadequate consideration while the purchaser is insolvent or knows that he soon will be insolvent, or with actual intent to hinder, delay, or defraud creditors, the bank, as a creditor, may set aside the conveyance. *See* UNIFORM FRAUDULENT CONVEYANCE ACT §§ 4, 6, 7, 9, 10. Similar rules exist in states that have not adopted the Uniform Fraudulent Conveyance Act. *See generally* 37 AM. JUR. 2d *Fraudulent Conveyances* §§ 5-6 (1968).

89. *E.g.*, Pennsylvania v. Curtiss Nat'l Bank, 427 F.2d 395 (5th Cir. 1970); Banco Ganadero y Agricola v. Society Nat'l Bank, 418 F. Supp. 520 (N.D. Ohio 1976); Laurel Bank & Trust Co. v. City Nat'l Bank, 33 Conn. Supp. 641, 365 A.2d 1222 (Super. Ct. 1976); Bank of Niles v. American State Bank, 14 Ill. App. 3d 729, 303 N.E.2d 186 (1973); State Bank v. American Nat'l Bank, 266 N.W.2d 496 (Minn. 1978).

90. *See* Swiss Credit Bank v. Virginia Nat'l Bank, 538 F.2d 587 (4th Cir. 1976); Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620 (7th Cir. 1973); Kaufman v. Chase Manhattan Bank, 370 F. Supp. 276 (S.D.N.Y. 1973).

91. *See* cases cited in note 89 *supra*.

92. *See* cases cited in note 89 *supra*; 6D W. WILLIER & F. HART, *supra* note 23, § 4-403, at 2-1194; Benson, *supra* note 23, at 450; Wallach, *supra* note 23, at

upon whether the third party demanding payment is a holder in due course.[93]

In *Laurel Bank & Trust Co. v. City National Bank*,[94] the purchaser gave the bank one of its own personal checks as consideration for a cashier's check. It then transferred the cashier's check in payment of an antecedent debt. The purchaser's personal check was subsequently dishonored for insufficient funds. The court determined that the transferee of the cashier's check was a holder in due course,[95] and therefore held that section 3-305(2) precluded the bank from raising the defense of failure of consideration.[96] In dictum, the court noted that, under section 3-306(b), the bank could raise the defense of failure of consideration against a person not having the rights of a holder in due course.[97] Similarly, in *Pennsylvania v. Curtiss National Bank*,[98] the court observed that had it not found adequate consideration for the cashier's check in question, it would have allowed the bank to raise the defense of failure of consideration against a party not having the rights of a holder in due course.[99]

Applying sections 3-305 and 3-306 to such cases requires resolution of the difficult question of who can qualify as a holder in due course of a cashier's check. Under the literal terms of the Code, a holder who has taken for value and in good faith is denied holder in due course status only when he has notice of a claim to or defense against the instrument itself.[100] There is pre-Code authority, however, supporting the proposition that notice of a purchaser's defense against the holder arising from the underlying transaction, although certainly not available to the bank as a defense, deprives the holder of holder in due course status.[101] Thus, notice of the de-

590-91; Note, *Adverse Claims and the Consumer: Is Stop Payment Protection Available?*, *supra* note 23, at 919-20.

93. Since the bank has not dealt with the holder, it is foreclosed by U.C.C. § 3-305(2) from raising any defense other than real defenses (infancy, incapacity, duress, etc.) against a holder in due course. But under U.C.C. § 3-306(b) and (c), regardless of whether the bank has dealt with the holder, the bank can raise any of its defenses if the holder is not a holder in due course.

94. 33 Conn. Supp. 641, 365 A.2d 1222 (Super. Ct. 1976).

95. *Id.* at 646, 365 A.2d at 1225.

96. *Id.* at 647, 365 A.2d at 1226.

97. *Id.* at 643, 365 A.2d at 1225.

98. 427 F.2d 395 (5th Cir. 1970).

99. *Id.* at 399.

100. U.C.C. § 3-302(1)(c).

101. There appear to be no cases arising under the U.C.C. deciding the issue of whether a holder who has notice of the purchaser's defenses on the underlying transaction is denied the status of a holder in due course. There are pre-

fective nature of an automobile might deprive the automobile dealer of holder in due course status if he accepts payment by cashier's check. This is true even though the bank could not raise a breach of warranty defense against the dealer in an action for payment.[102] If the dealer loses its holder in due course status, it then becomes subject to the bank's defense of failure of consideration.[103] Consequently, the holders of cashier's checks who do not qualify as holders in due course may also include certain persons who have had no notice of the bank's own defenses to the instrument and who gave value to the purchaser in exchange for the cashier's check.

It could also be argued that section 3-418 should determine when a bank may raise its own defenses against a holder with whom it has not dealt. Since section 3-418 controls this issue with respect to certified checks,[104] it seems logical that the courts which treat cashier's checks as accepted drafts should apply this section.[105] No court, as of yet, has so held. Under section 3-418, regardless of whether the bank has dealt with the holder, the bank is foreclosed from raising any defense on the holder's action if the holder is a holder in due course or has changed position in good faith reliance on the acceptance. In the context of cashier's checks, this rule raises the difficult interpretive problem of determining whether a holder qualifies as a holder in due course[106] or whether a holder has changed position in good faith.[107]

U.C.C. cases on the analogous issue of whether a holder with notice of the payee's defenses is a holder in due course with respect to the maker. The general rule was that such knowledge did not preclude holder in due course status with respect to the obligor's defenses. *See* Baird v. Lorenz, 57 N.D. 804, 808, 224 N.W. 206, 208 (1929); Long v. City Nat'l Bank of Commerce, 256 S.W. 1006, 1010 (Tex. Civ. App. 1923); Dollar Sav. & Trust Co. v. Crawford, 69 W. Va. 109, 116, 70 S.E. 1089, 1091 (1911); W. BRITTON, *supra* note 43, § 117, at 296. However, there are cases to the contrary. *See* Walker v. Bartlesville State Bank, 91 Okla. 231, 232, 216 P. 928, 929 (1923); Fehr v. Campbell, 288 Pa. 549, 560, 137 A. 113, 117 (1927).

102. *See* U.C.C. § 3-306(d). Since breach of warranty is a mere defense and not a claim of ownership, an issuing bank may not raise the purchaser's breach of warranty defense even against one who is not a holder in due course.

103. *Id.* § 3-306(b), (c).

104. *See* note 73 *supra* and accompanying text.

105. *See* Wertz v. Richardson Heights Bank & Trust, 495 S.W.2d 572, 575-76 (Tex. 1973) (Walker, J., dissenting); text accompanying notes 73-76 *supra*.

106. *See* note 101 *supra* and accompanying text.

107. Since acceptance is final not only as to holders in due course but also as to persons who have in good faith changed position in reliance on the acceptance, *see* notes 211-214 *infra* and accompanying text, the bank is foreclosed from raising any defenses against the holder if he so qualifies. The first problem in applying this standard is determining whether a holder who has notice of one of the purchaser's defenses, but not of the bank's defenses, can be said

The strict application of either sections 3-305 and 3-306, or section 3-418 to situations in which the issuing bank has not dealt with the holder would create certain anomalies. Consider again the example of a car dealer who sells a car with knowledge that it is defective. If the dealer receives payment by check, he probably would not enjoy the status of a holder in due course.[108] If the check were a personal check, the seller would be entitled to recover the full purchase price less the buyer's damages. But if the seller, in order to assure himself of payment, had required payment by cashier's check, it is conceivable that he might not be able to recover anything against either the buyer or the bank. This anomalous result could occur if the buyer of the car obtained the cashier's check by giving the bank a forged payroll check, or in some other way failed to give value for the check. Under sections 3-306 or 3-418, the bank could raise this failure of consideration as a total defense to an action for payment by the car dealer. Thus, even though the buyer of the car would have a claim only for his loss due to the defect, the bank would have a defense to the entire face

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to have changed position in good faith when he releases the goods to the purchaser upon receipt of the check. In other words, has the holder exhibited the necessary "honesty in fact," *see* U.C.C. § 1-201(19), that is required for good faith? The second problem is determining what constitutes a change of position in reliance on the acceptance of the check. Although it is clear that the relinquishment of goods or the rendition of services in return for a check constitutes a sufficient change of position, it is not clear whether accepting the check in payment of an antecedent debt would be sufficient, even though the holder might have refrained from commencing suit on the debt in reliance on the check. Similarly, it is not clear whether the fact that under U.C.C. § 3-802(1) the holder has lost his cause of action against the purchaser on the underlying transaction constitutes a change of position. Although there are no post-U.C.C. cases on point, certain pre-U.C.C. cases, which consider the same question with reference to check certification procured by the holder, have held that the discharge of the drawer is a sufficient change of position. *See* Times Square Auto. Co. v. Rutherford Nat'l Bank, 77 N.J.L. 649, 650, 73 A. 479, 480 (1909); Fiss Corp. v. National Safety Bank & Trust Co., 191 Misc. 397, 398, 77 N.Y.S.2d 293, 294 (City Ct. 1948). Another possibility leading to the same result is that the holder is not considered to have changed position, but that the purchaser's liability is reinstated on the underlying transaction. In certain cases where a drawee certified a check despite the fact that there were insufficient funds in the drawer's account, or that a stop payment order had been issued by the drawer, the courts have held that the drawer was not released on either the check or the underlying obligation, since it was the drawer's own actions that created the situation. *See* Condenser Serv. & Eng'r Co. v. Mycalex Corp., 7 N.J. Super. 427, 430, 71 A.2d 404, 406 (Super. Ct. Law Div. 1950); Baldinger & Kupferman Mfg. Co. v. Manufacturers-Citizens Trust Co., 93 Misc. 94, 98, 156 N.Y.S. 445, 447 (App. Term 1915); Plantation's Bank v. Desormier, 102 R.I. 565, 568-69, 232 A.2d 371, 374 (1967).

108. *See* note 101 *supra*. Or, consider instead that the holder is not a holder in due course because, by taking the check more than thirty days after its issuance, he has notice that it is overdue. U.C.C. § 3-304(3)(c).

amount of the check. As payee on the cashier's check, the car dealer has no recourse on the instrument against the purchaser of the check; yet under section 3-802(1),[109] by accepting a check with a bank as a drawer and without recourse against the purchaser, it is likely that the car dealer has lost his cause of action against the purchaser on the underlying obligation.

In addition to producing such anomalies, the strict application of either sections 3-305, 3-306, or 3-418 would have an adverse impact on the cash equivalency of cashier's checks. A few courts have focused on the cash-like nature of cashier's checks, and accordingly have prohibited banks from raising any of their own claims or defenses against holders with whom they have not dealt.[110] For instance, in *Kaufman v. Chase Manhattan Bank*,[111] the issuing bank had neglected to debit the purchaser's account for the amount of a cashier's check. The court, without even questioning whether the holder was a holder in due course, refused to allow the bank to raise this defense. It reasoned that the bank could have protected itself by ensuring that it had received payment for the cashier's check before issuance.[112] Moreover, the court emphasized the policy consideration that unless the bank's liability on the check is absolute, the bank's solvency would provide insufficient protection to the holder who has decided to take a cashier's check instead of cash.[113]

As the *Kaufman* opinion implies, the application of present Code provisions to cashier's checks—an application that would allow issuing banks to litigate with some frequency their own defenses to payment—would strip these instruments of their role as cash substitutes. First, because of the many reasons that a transferee might not be considered a holder in due course,[114] application of the Code could subject transferee-

109. U.C.C. § 3-802(1) provides that "[u]nless otherwise agreed where an instrument is taken for an underlying obligation (a) the obligation is pro tanto discharged if a bank is drawer, maker or acceptor of the instrument and there is no recourse on the instrument against the underlying obligor." For support of the contrary proposition that the purchaser's liability on the underlying transaction should be reinstated if the bank can refuse payment on the cashier's check because of its own defense against the purchaser, see note 107 *supra*.

110. *See* Swiss Credit Bank v. Virginia Nat'l Bank, 538 F.2d 587, 588 (4th Cir. 1976); Kaufman v. Chase Manhattan Bank, 370 F. Supp. 276, 278-79 (S.D.N.Y. 1973).

111. 370 F. Supp. 276 (S.D.N.Y. 1973).

112. *Id.* at 278.

113. *See id.* at 278-79 (quoting National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 351, 268 A.2d 327, 329 (Super. Ct. Law Div. 1970)).

114. Reasons that holders may not qualify as holders in due course include

holders to several defenses the existence of which they are in no position to be aware. This is because transferee-holders are not normally party to the transactions from which the defenses of issuing banks arise. Second, and perhaps more important, application of the Code would frequently compel holders to commence legal proceedings in order to recover on the check. This result would force holders rather than banks to incur the risk of litigation as well as the risk of the lost use of funds during the pendency of the action.

3. *The Bank's Ability to Raise the Purchaser's Claims and Defenses*

More common than the situation in which the bank has a defense of its own to payment is the one in which the purchaser of a cashier's check has a claim or defense arising from the transaction in which he negotiated the check to the payee. For example, goods paid for with a cashier's check may turn out to be defective, resulting in a breach of the payee's warranty of fitness. Although the purchaser of the cashier's check may not order the bank to stop payment,[115] the issuing bank may voluntarily accommodate the purchaser's request that it refuse payment, and force the holder to bring suit for payment. If the purchaser is unable to persuade the bank to refuse payment, the purchaser may attempt to prevent payment by asserting an adverse claim to the check.[116] Whether the bank or the purchaser pursues these options depends largely upon the ability of the bank to utilize the claims and defenses of the purchaser and upon the ability of the purchaser to successfully assert an adverse claim.

It is important to realize that such issues arise only when the holder is not a holder in due course. When a cashier's check is held by a holder in due course, it is clear that no claim or defense of a third party may be raised by the obligor.[117]

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the following: failing to obtain an indorsement, U.C.C. § 1-201(20); having notice of a claim or defense of either the purchaser or the bank, *id.* § 3-302(1)(c); *see* note 101 *supra*; taking the instrument after it is overdue, U.C.C. §§ 3-302(1)(c), -304(3)(c); or failing to give value for the instrument, U.C.C. §§ 3-302(1)(a), -303.

115. *See* note 52 *supra* and accompanying text.

116. *See* notes 122-134 *infra* and accompanying text.

117. This result is reached under all three of the theories this Article has considered regarding obligations on cashier's checks. First, under U.C.C. § 3-305, a holder in due course takes free of all claims of all parties, and of all defenses except certain real defenses of the instrument's obligor, and not of third parties. *See* Wallach, *supra* note 23, at 590 n.44; Note, *supra* note 31, at 547. The defenses of a holder with whom the obligor has dealt are inapplicable in this factual setting, since the obligor has not dealt with the holder. Second, under

Both common law and the Code provide that a holder in due course of any type of negotiable instrument takes free of all claims and defenses of third parties.[118] This rule is based on the judgment that society's interest in ensuring negotiability clearly outweighs the occasional harshness of denying a third party the right to raise a rightful claim to or defense against a negotiable instrument.[119]

When a holder is not a holder in due course, though, courts and commentators have disagreed on the questions of whether a bank can raise a purchaser's claims or defenses, and whether a purchaser can assert his own adverse claims. The commentators generally take the position that in this situation the provisions of the Code governing ordinary negotiable instruments should also govern the respective rights of the parties to a cashier's check.[120] The courts, on the other hand, almost uniformly take the opposite view, reasoning implicitly that the value judgment exemplified by the Code—which limits the free negotiability of ordinary negotiable instruments—is overridden by society's interest in having cashier's checks serve as cash substitutes.[121] As a result, the courts usually ignore the Code when a bank attempts to raise a claim or defense of the purchaser, or when a purchaser attempts to assert an adverse claim against an instrument held by one who is not a holder in due course.

a. Theoretical Applicability of Sections 3-306 and 3-603(1)

Sections 3-306[122] and 3-603(1)[123] appear to apply to the situ-

U.C.C. § 3-418, acceptance is final as to holders in due course. Thus, if cashier's checks are considered accepted drafts, the issuing bank is absolutely liable to the holder and cannot raise any claims or defenses of its own or of third parties. Finally, if cashier's checks are regarded as cash substitutes, the bank obviously cannot be permitted to raise any third-party claims or defenses against a holder in due course.

118. U.C.C. § 3-305; N.I.L. § 57. *See generally* Strahorn, *The Policy or Function of the Law of Bills and Notes*, 87 U. PA. L. REV. 662 (1939).

119. *See* Strahorn, *supra* note 118, at 663. For a critical analysis of the value of negotiability, see Rosenthal, *Negotiability—Who Needs It?*, 71 COLUM. L. REV. 375 (1971).

120. *See* authorities cited in note 23 *supra*.

121. *See* State *ex rel.* Chan Siew Lai v. Powell, 536 S.W.2d 14, 16 (Mo. 1976); Thompson Poultry, Inc. v. First Nat'l Bank, 199 Neb. 8, 9, 255 N.W.2d 856, 857-58 (1977); National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 351, 268 A.2d 327, 329 (Super. Ct. Law Div. 1970); Tranarg v. Banca Commerciale Italiana, 90 Misc. 2d 829, 832-33, 396 N.Y.S.2d 761, 763 (Sup. Ct. 1977); Moon Over the Mountain, Ltd. v. Marine Midland Bank, 87 Misc. 2d 918, 921, 386 N.Y.S.2d 974, 976 (Civ. Ct. N.Y. 1976). *But see* Leo Syntax Auto Sales v. Peoples Bank & Sav. Co., 6 Ohio Misc. 226, 229-30, 215 N.E.2d 68, 71 (1965).

122. The text of U.C.C. § 3-306 is quoted in note 38 *supra*.

123. U.C.C. § 3-603(1) provides:

ation in which a bank attempts to raise a claim or defense of the purchaser, or in which the purchaser attempts to assert an adverse claim against a cashier's check. Section 3-306 sets out the rules generally applied in determining the claims and defenses subject to which one who is not a holder in due course takes an instrument. Section 3-306(a) provides that a person not having the rights of a holder in due course takes subject to "all valid claims to [the instrument] on the part of any person," but does not address the issues of whether an obligor is permitted or can be compelled to raise the claims of a third party. Sections 3-306(d) and 3-603(1), however, treat these issues insofar as ordinary negotiable instruments are concerned. Some commentators have assumed that these sections should also govern whether third-party claims or defenses may be raised against the holder of a cashier's check who is not a holder in due course.[124] An inquiry into the operation of these sections is therefore necessary.

As a preliminary matter, the distinction between defenses and claims of ownership must be clarified. The term "claim," as it is used in sections 3-306(d) and 3-603(1), encompasses both legal and equitable claims.[125] A legal claim of ownership in-

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The liability of any party is discharged to the extent of his payment or satisfaction to the holder even though it is made with knowledge of a claim of another person to the instrument unless prior to such payment or satisfaction the person making the claim either supplies indemnity deemed adequate by the party seeking the discharge or enjoins payment or satisfaction by order of a court of competent jurisdiction in an action in which the adverse claimant and the holder are parties. This subsection does not, however, result in the discharge of the liability

(a) of a party who in bad faith pays or satisfies a holder who acquired the instrument by theft or who (unless having the rights of a holder in due course) holds through one who so acquired it; or

(b) of a party (other than an intermediary bank or a payor bank which is not a depositary bank) who pays or satisfies the holder of an instrument which has been restrictively indorsed in a manner not consistent with the terms of such restrictive indorsement.

124. *See* authorities cited in note 23 *supra*. These commentators treat the problem as one of *jus tertii*—the ability of an obligor to raise the claims or defenses of a third party in order to defend against his own liability on the instrument. The assumption that sections 3-306(d) and 3-603(1) apply is understandable when made by those who treat cashier's checks as notes, since courts have consistently applied these sections to determine whether the maker of a note can raise third-party claims or defenses. *See* note 36 *supra*. The commentators who treat cashier's checks as accepted drafts, however, *see* note 36 *supra*; text accompanying notes 41-42 *supra*, should logically apply section 3-418, which makes acceptance final even as to certain parties who are not holders in due course.

125. The distinction between legal claims and equitable claims and de-

volves the assertion by the owner that he has been wrongfully and involuntarily deprived of possession. Such claims normally arise from theft or loss of the instrument. An equitable claim of ownership involves the assertion by the owner that he has been induced to part voluntarily with the instrument under circumstances that give him a right to rescind the transaction and reclaim the instrument.[126] Equitable claims commonly stem from transactions involving mistake, fraud, duress, or illegality.[127] Both legal and equitable claims, therefore, are based on the fact that the instrument's holder is in wrongful possession.

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fenses is explained in Note, *supra* note 5, at 428 n.29. The classic definitions of legal title, equitable title, and contract defenses as they apply to negotiable instruments were given by Professor Chafee, who formulated the following definition of legal title: "The legal title to a negotiable instrument throughout its existence belongs to the person to whom the promises run by the terms of the instrument if he has possession, no matter how that possession came to him." Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104, 1112 (1918). *See also* W. BRITTON, *supra* note 43, § 156, at 456-62. Under this formulation, a thief has legal title to a negotiable instrument payable to bearer or indorsed in blank, but a possessor under a forged instrument has no legal title because he is not a promisee under the terms of the instrument. Chafee's distinction between equities of ownership and equities of defense is based on the dual nature of a negotiable instrument. Equities of ownership relate to the instrument as a chattel:

> It is a chattel, a tangible scrap of paper, sometimes valuable for its own sake if sufficiently ancient or bearing the autograph of some historic debtor . . . , always available for framing or even papering the walls, for which purpose unlucky investors have used their coupon bonds. As a chattel, it is the subject of conversion which gives rise to trover, has been held to be covered by the designation "goods and chattels" in the Statute of Frauds, and is taxable where situated, though the owner and the obligor reside elsewhere.

Chafee, *supra*, at 1109. Any equitable claim of right to possession of the actual paper is therefore a claim of equitable ownership. For example, if the payee of an instrument is induced by fraud to indorse and deliver the instrument to a third party, the payee has an equitable right to restitution of the document. Equities of defense relate to the negotiable instrument as a bundle of contracts. *Id.* "Instead of being property rights . . . , they are set up by a defendant as defenses . . . to litigation on a contract." *Id.* at 1111. Equities of defense are the ordinary personal defenses, such as failure of consideration, fraud, duress, and nonfulfillment of a condition precedent, that can be asserted by a party to a commercial transaction to void his payment instrument. *See also* Note, *Adverse Claims and the Consumer: Is Stop Payment Available?, supra* note 23, at 921-24.

U.C.C. § 3-603(1) appears, however, to adopt a different line of demarcation between legal and equitable claims of ownership. When, for instance, bearer paper is stolen, section 3-603(1)(a) recognizes legal title to the paper in the victim rather than the thief. *See id.* § 3-603, Official Comment 5.

126. *See* discussion of equitable claims in note 125 *supra*.

127. *Id. See* U.C.C. § 3-306, Official Comment 5. An equitable claim, of course, must be the cause of the owner parting with the instrument, not an unrelated set-off.

When the holder is in rightful possession of the instrument, the original owner may thus raise only defenses to payment. Breach of warranty and failure of consideration on the underlying contract are common examples of such defenses. The circumstances that give rise to a purchaser's defenses against a holder frequently differ only in degree from those that give rise to equitable claims.[128] To illustrate this difference, consider once more the example of the used car dealer who obtains payment by negotiable instrument for an auto that he has misrepresented as being free from defects. The obligor can defend against its obligation on the instrument by asserting equitable ownership in the buyer[129] only if the misrepresentations of the dealer were so extreme that the buyer himself would be permitted to rescind the transaction. If the misrepresentations were less serious, the buyer could not be the equitable owner of the instrument and would merely have a cause of action for breach of warranty against the dealer. The obligor, then, would be fully liable on the instrument since he cannot defend against payment by invoking a mere defense of the buyer.[130]

It may appear puzzling that the Code would allow obligors in this situation to defend against payment on negotiable instruments by asserting third-party claims, but not by raising third-party defenses. This distinction does not reflect any conscious value judgment that claims of ownership are more meritorious than ordinary defenses.[131] Rather, it simply represents the draftsmen's intent to permit an obligor to raise a claim of ownership against a holder when the obligor cannot obtain a discharge by paying the holder under section 3-603(1).[132] Section 3-603(1) is essentially a codification of the common law rules of discharge[133] aimed at alleviating some of the problems

128. *See* Note, *Adverse Claims and the Consumer: Is Stop Payment Protection Available?, supra* note 23, at 924.

129. The U.C.C. does not define claims of ownership, but leaves this determination to state law on rescission. *See* U.C.C. § 3-306, Official Comment 5.

130. *See* Wallach, *supra* note 23, at 589.

131. Of course, it does indirectly evince such a value judgment since under U.C.C. § 3-603(1) an obligor will obtain a discharge by payment to a holder who has notice of a defense of a third party notwithstanding indemnification or injunction, or even to a holder who has notice of an equitable claim, unless the obligor is indemnified or the third party obtains an injunction. An obligor will not obtain a discharge with notice of a legal claim of ownership. For a discussion of the distinction between legal and equitable claims, see notes 125-126 *supra* and accompanying text.

132. For the full text of U.C.C. § 3-603(1), see note 123 *supra*.

133. *See* Note, *Personal Money Orders and Teller's Checks: Mavericks Under the UCC, supra* note 23, at 544, 545; Note, *supra* note 5, at 431; Note, *Adverse*

that existed under the discharge provisions of the N.I.L.[134]

Under the N.I.L., there was confusion about the ability of an obligor to obtain a discharge from liability by paying an instrument's holder when the obligor had knowledge of a third-party claim of ownership.[135] The rule was that if the obligor did not pay in due course, he was not discharged from liability on the instrument and could be successfully sued by the real owner.[136] Thus, if an obligor only had notice of an ordinary defense against the instrument, he could pay in due course since the rightful owner would be known.[137] Notice of a claim of ownership, however, whether legal or equitable, was generally sufficient to disable the obligor from paying in due course.[138] A nonholder could therefore force an obligor to voice a third-party claim of ownership simply by giving the obligor notice. The inability of obligors to obtain a discharge by paying the holder once notice of a claim of ownership had been given created the distinct possibility of double liability.[139] If an obligor paid the holder, the third-party claimant needed only to prove the validity of his claim in order to hold the obligor liable. If, on the other hand, the obligor refused to pay the holder, he exposed himself to the costs of defending a lawsuit brought by the holder. Moreover, even if the holder's suit was successful, the obligor was still potentially liable to the third-party claimant in a subsequent action on the instrument. Since the third-party claimant would not ordinarily be a party in the holder's action, he would not be bound by the results of the holder's action.[140] Contradictory results were therefore possible because, in an action for payment brought by a holder, an obligor rarely had information sufficient to present the best case for the third-party claimant.

The draftsmen of the Code sought to alleviate these risks by removing the possibility of double liability.[141] Reverting to

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Claims and the Consumer: Is Stop Payment Protection Available?, supra note 23, at 923.

134. *See* Note, *supra* note 5, at 431; Comment, *Adverse Claims Under the Uniform Commercial Code: A Survey and Proposals*, 65 YALE L.J. 807, 812 (1956).

135. *See* Note, *Jus Tertii Under Common Law and the N.I.L.*, 26 ST. JOHN'S L. REV. 135, 138 (1951); Comment, *supra* note 134, at 810-12.

136. *See generally* authorities cited in note 135 *supra*.

137. *Id.*

138. *Id.*

139. *Id.*

140. *See* Comment, *supra* note 134, at 811.

141. *See* Comment, *Adverse Claims and the Consumer: Is Stop Payment Protection Available?, supra* note 23, at 920; Comment, *supra* note 134, at 812-13.

the common law approach, they established more liberal rules for discharge. With respect to equitable claims of third parties, Code section 3-603(1) permits obligors, even if they have had notice, to obtain discharge by paying the holder unless the third-party claimant insulates the obligor from double liability by either of two methods: posting an indemnity bond, or obtaining an injunction in a court action to which both the holder and the obligor are party. With respect to legal claims of ownership, on the other hand, section 3-603(1) provides that notice of a third-party claim disables the obligor from obtaining a discharge by paying the holder.[142] Two reasons support the different treatment the Code accords legal claims. First, if obligors are prohibited from obtaining discharge when, with notice, they pay a holder whose title can be traced to a thief, this will act as a strong incentive for obligors to make it more difficult for thieves to transfer or obtain payment on negotiable instruments.[143] Second, it should be significantly easier for an obligor to prove that an instrument has been stolen than to prove that a third party has an equitable right to rescind the conveyance of an instrument.

The provisions of section 3-306(d) were developed to complement section 3-603(1).[144] Under section 3-306(d), obligors can raise the claims or defenses of a third party only when the obligors need to avoid the possibility of double liability, that is, when an adverse claim can be asserted. Thus, an obligor may always raise a third party's legal claim of ownership in an action for payment by the holder. The Code permits obligors to assert such claims regardless of whether the third-party claimant is party to the suit, since obligors cannot obtain a discharge by paying the holder if the obligor has notice of the legal claim.[145] Obligors, however, may raise the equitable claim of a

142. U.C.C. § 3-603(1)(a).

143. *Id.* § 3-306, Official Comment 5.

144. *See* U.C.C. § 3-306, Official Comment 5.
Section 3-306 of the U.C.C. provides:

> Unless he has the rights of a holder in due course any person takes the instrument subject to . . . (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.

145. *See* U.C.C. § 3-603(1)(a). There is, nevertheless, a risk of double liability in this situation. If the holder is successful in his action against the obligor, the judgment, because it is not res judicata as to the third-party claimant not party to the action, fails to protect the obligor in a subsequent action by that

third party only when the third party defends the action for the obligor. This is because the obligor may discharge his liability by paying the holder except when the third-party claimant indemnifies the obligor or obtains a judgment restraining payment. Consequently, there is no need to allow an obligor to raise the equitable claim of a third party unless the claimant defends the suit for the obligor.[146] Finally, obligors may never raise the ordinary defenses of third parties, because obligors may discharge their obligation by paying the holder even when they have notice of the defenses.

If sections 3-306 and 3-603(1) were applied to cashier's checks, both the issuing bank and the purchaser would be disabled from asserting the purchaser's ordinary defenses in an action for payment brought by the holder. Only the purchaser's adverse claims of ownership would be available to the bank for resisting payment. Commentators have assumed such an application to be wholly proper, apparently because of the absence of any other Code provisions that seem to treat the matter.[147] This assumption, however, ignores the possibility that the differences between society's perceptions of ordinary negotiable instruments and cashier's checks may merit a different formulation of the rights of parties to cashier's checks. This possibility militates strongly against applying sections 3-306 and 3-603(1) to cashier's checks. Failing to apply these sections does not appear to contravene the intention of the draftsmen, for there is no indication that they expected these sections to govern cashier's checks.[148]

If cashier's checks are to be viable cash substitutes, even the title of one who is not a holder in due course should be superior to a third party's adverse claim of ownership. In a cash transaction, the transferee has use of the funds during the pendency of any action arising out of the transfer. If the transferor,

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claimant. The draftsmen must have felt that the ease of proving lack of legal title, even without the assistance of the true owner, and the strong public policy interest against aiding thieves outweighed this risk of double liability.

146. This protects obligors against double liability since they can obtain discharge by paying holders unless a third-party claimant is able to prove, in an action in which all interested parties are present, that the true owner of the instrument is the third-party claimant. Similarly, obligors cannot totally avoid payment, and thus be unjustly enriched, by succeeding in separate suits against the holder and the third-party claimant.

147. *See generally* authorities cited in note 23 *supra*.

148. The cases that have been cited for the proposition that adverse claim procedures apply to bank checks have involved certified checks. *See generally* Note, *supra* note 5. No pre-U.C.C. or post-U.C.C. cases have permitted adverse claims against a cashier's check.

by attachment, deprives the transferee of the use of the cash, he must indemnify the transferee against wrongful attachment.[149] Applying sections 3-306 and 3-603(1) to cashier's checks, however, would permit a purchaser to assert his claim of ownership merely by posting a bond indemnifying the bank, not the holder. During the ensuing lawsuit, the holder would not only lose the use of funds, but would also incur the costs of litigation. Thus, sections 3-306 and 3-603(1) clearly provide an unsatisfactory framework for regulating cashier's checks. The value judgments underlying these sections apply to ordinary negotiable instruments, not to cashier's checks.[150]

b. Refusal of Courts to Apply Sections 3-306 and 3-603(1)

Realizing that sections 3-306(a), 3-306(d), and 3-603(1) would prevent cashier's checks from fulfilling their perceived role as cash equivalents, courts have avoided applying them to cashier's checks.[151] Unfortunately, the courts have often cited inappropriate Code sections to justify this result.[152]

The courts have reasoned that to permit a bank to raise the claims or defenses of a check's purchaser would destroy the utility of cashier's checks as "executed sales of credit" or cash substitutes. As a result, in virtually every case involving the negotiation of a cashier's check to a holder whose title is questionable, the courts have denied banks the opportunity to raise the purchaser's defenses or claims as a defense against its obligation to pay.[153] Similarly, no court has allowed a purchaser or

149. Most jurisdictions require the posting of a bond as a condition precedent to the issuance of a writ of attachment. *See, e.g.*, CAL. CIV. PROC. CODE § 489.220(a) (West 1979); ILL. ANN. STAT. ch. 11, § 4(a)-(b) (Smith-Hurd 1963); N.Y. CIV. PRAC. LAW § 6212(b) (McKinney 1964).

150. The application of section 3-418 to cashier's checks is more satisfactory than the application of sections 3-306 and 3-603(1), but it too is inadequate to ensure any independent function for such checks. Under section 3-418, the holder, if he is a holder in due course or has changed position in reliance on the receipt of the check, takes free of any third-party claims or defenses. If the holder does not qualify under either class of protected persons, he will be subject to all of the purchaser's claims or defenses. If the courts broadly interpret the phrases "holder in due course" and "good faith change of position," the holder might be protected in every situation where commercial necessity dictates protection. But the vagueness of these standards permits banks, or the purchasers who assert adverse claims, to require a check's holder to commence a lawsuit to prove that acceptance is final as to him. Thus, section 3-418 fails to shift the risk of litigation or the risk of lost use of funds away from the holder.

151. *See* cases cited in note 121 *supra*.

152. *See* cases cited in note 50 *supra*.

153. *See, e.g.*, cases cited in note 121 *supra*. There were several pre-U.C.C. cases that permitted the bank to raise the purchaser's claims or defenses. *See, e.g.*, First Nat'l Bank v. Associates Inv. Co., 140 Ind. App. 394, 221 N.E.2d 684

any other third party to assert an adverse claim to a cashier's check.[154] In fact, at least four cases have held by implication that the equitable claim of a purchaser or other third party to a cashier's check is inferior even to the title of one who is not a holder in due course, and that, therefore, no such claim can be asserted by a resisting bank.[155]

The most widely cited of these cases is *National Newark & Essex Bank v. Giordano*,[156] in which the issue presented was whether a bank issuing a cashier's check was liable to the purchaser when the bank had paid the check over a stop payment order and an offer to post an indemnity bond. The court, finding the bank not liable, stated: "A cashier's check circulates in the commercial world as the equivalent of cash . . . . People would no longer be willing to accept it as a substitute for cash if they could not be sure that there would be no difficulty in converting it into cash."[157] In *National Newark*, the purchaser may have had an equitable claim to the check since the holder allegedly misrepresented the quality of the goods given in exchange for the check.[158] The court reasoned, however, that the

(1966). *See generally* H. BAILEY, BRADY ON BANK CHECKS § 13.7 (4th ed. 1969). However, there is only one post-U.C.C. case that has permitted a bank to raise either the claims or defenses of a purchaser. *See* Leo Syntax Auto Sales v. Peoples Bank & Sav. Co., 214 N.E.2d 68 (Ohio 1965). In *Syntax*, an action brought by one who was not a holder in due course, the court ignored the U.C.C. and applied pre-U.C.C. law, permitting a bank to raise not only the purchaser's equitable claim of rescission for fraud, but also the purchaser's breach of warranty defense. The purchaser was not a party to the action. Even the commentators who view cashier's checks as notes have criticized the *Syntax* court for failing to properly apply section 3-306(d). *See, e.g.*, 6D W. WILLIER & F. HART, *supra* note 23, § 4-403, at 2-1194.

154. The Appellate Division of the New York Supreme Court has held, in Dziurak v. Chase Manhattan Bank, 58 A.D. 2d 103, 106-07, 396 N.Y.S.2d 414, 416-17 (1977), *aff'd mem.*, 44 N.Y.2d 776, 377 N.E.2d 474, 406 N.Y.S.2d 30 (1978), that a stop payment order issued by a purchaser is not sufficient to compel a bank to refuse to pay a cashier's check. In dictum, however, the court stated that the purchaser could have asserted an adverse claim by complying with the requirements of U.C.C. § 3-603(1). 58 A.D.2d at 106-07, 396 N.Y.S.2d at 417. The Court of Appeals affirmed, without referring to the ability of a purchaser to assert an adverse claim under U.C.C. § 3-603(1). 44 N.Y.2d 776, 377 N.E.2d 474, 406 N.Y.S.2d 30 (1978).

155. *See* State *ex rel.* Chan Siew Lai v. Powell, 536 S.W.2d 14 (Mo. 1976); National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 268 A.2d 327 (Super. Ct. App. Div. 1970); Moon Over the Mountain, Ltd. v. Marine Midland Bank, 87 Misc. 2d 918, 386 N.Y.S.2d 974 (Civ. Ct. N.Y. 1976); Tranarg v. Banca Commerciale Italiana, 90 Misc. 2d 829, 396 N.Y.S.2d 761 (Sup. Ct. 1977). *See also* Thompson Poultry, Inc. v. First Nat'l Bank, 199 Neb. 8, 255 N.W.2d 856 (1977) (money order).

156. 111 N.J. Super. 347, 268 A.2d 327 (Super. Ct. App. Div. 1970).

157. *Id.* at 351-52, 268 A.2d at 329 (citation omitted).

158. *Id.* at 353, 268 A.2d at 329-30.

bank had accepted the check upon issuance and that, since it is impossible to stop payment on a check once it is accepted,[159] the bank could not raise even the purchaser's equitable claim of ownership as a defense to its obligation on the check. Implicit in this reasoning is the judgment that the title of a holder who is not a holder in due course is superior to a purchaser's equitable claim of ownership or, in other words, that section 3-306(a) does not apply to cashier's checks. In attempting to reconcile its holding with the Code, the court relied on section 4-403(1) for the proposition that the purchaser has no right to stop payment on a cashier's check. This is unfortunate since, as previously discussed,[160] the purchaser's inability to stop payment on a cashier's check does not determine whether the bank can raise the purchaser's claims or defenses, or whether the purchaser can assert an adverse claim.

In *Moon Over the Mountain, Ltd. v. Marine Midland Bank*,[161] the court agreed that the role of cashier's checks as a cash substitute would be subverted if an issuing bank could be compelled to resist payment and raise the purchaser's claims or defenses, merely because the purchaser has agreed to indemnify the bank against liability.[162] In *Moon Over the Mountain*, the bank attempted to raise as a defense the purchaser's contention that the goods received from the holder were defective.[163] Although the case involved a defense rather than a claim of ownership, the court made no distinction between the bank's ability to raise either the claims or defenses of the purchaser. Like the court in *National Newark*, the *Moon Over the Mountain* court also invoked an inapplicable Code section to justify its holding. The court noted that under section 3-802(1) the purchaser's liability to the holder on the underlying transaction is discharged when the holder accepts the cashier's check; it therefore concluded that the bank should not be able to raise the purchaser's claims or defenses since the holder would then be left without a remedy.[164] Although this result is compelled by the interest the court notes in maintaining the cash-like nature of cashier's checks, section 3-802(1) does not support the court's conclusion. Unlike the case in which a bank raises its own defenses and thus totally deprives the holder of

159. *Id.* at 351-52, 268 A.2d at 329.
160. *See* text accompanying notes 51-59 *supra*.
161. 87 Misc. 2d 918, 386 N.Y.S.2d 974 (Civ. Ct. N.Y. 1976).
162. *Id.* at 923-24, 386 N.Y.S.2d at 977-78.
163. *Id.* at 919, 386 N.Y.S.2d at 975.
164. *Id.* at 920-21, 386 N.Y.S.2d at 976.

any recovery, if a bank were permitted to raise the purchaser's defenses, the holder would be liable only to the extent of a set-off in the amount that the purchaser would have recovered in a separate action against the holder.

The desire of courts to ensure that cashier's checks retain the characteristics of cash equivalency is probably most apparent in the case of *State ex rel. Chan Siew Lai v. Powell*.[165] In that case, the purchaser of a cashier's check obtained a temporary injunction which prohibited the issuing bank from paying a transferee of the check who was not a holder in due course. The purchaser alleged that the payee had accepted the check with the clear intention of not performing his part of the contract.[166] This action by the payee would clearly create an equitable claim to the check on the part of the purchaser.[167] On appeal, the Missouri Supreme Court dissolved the injunction even though it almost surely left the purchaser without any possibility of recovery. The facts in *Chan Siew Lai* could not have been more favorable for the purchaser. The payee was a resident and citizen of Hong Kong; the holder was a party to the action, begun in Missouri, but the payee was not. Since the injunction was denied, the court left the purchaser with two unrealistic alternatives: enforcing a judgment obtained in Missouri against the payee in Hong Kong, or commencing an independent action in Hong Kong. Although the *Chan Siew Lai* court also attempted to justify its decision by arguing the inability of a purchaser to issue a stop payment order under section 4-303(1)(a), its extensive quotation of the *National Newark* case[168] reveals that the actual reason behind its holding was that "public policy does not favor a rule that would permit stopping payment of [cashier's checks]."[169]

These decisions enforcing payment of checks in favor of holders who are not holders in due course affirm the fact that courts view cashier's checks as cash substitutes. The disregard of these courts, however, for apparently applicable provisions of the Code, such as sections 3-306 and 3-603(1), and their resort to clearly inapplicable Code sections, such as sections 4-403(1) and 3-802(1), diminishes the utility of the Code as a commercial

165. 536 S.W.2d 14 (Mo. 1976).
166. *Id.* at 15.
167. *See* notes 125-127 *supra* and accompanying text.
168. *See* State ex rel. Chan Siew Lai v. Powell, 536 S.W.2d at 16 (quoting National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 351-52, 268 A.2d 327, 329 (1970)); text accompanying note 49 *supra*.
169. 536 S.W.2d at 16.

planning aid. The problem is simple. In framing sections 3-306 and 3-603(1), the draftsmen of the Code considered only ordinary negotiable instruments. Apparently, they gave little thought to the independent commercial function of cashier's checks. The solution is equally simple. The integrity of the Code and the independent commercial function of cashier's checks can both be guaranteed by amending the Code to explicitly set forth the respective rights and liabilities of parties to cashier's checks.

C. A Program For Revision

In amending the Code, the draftsmen would find it necessary to balance society's interest in protecting issuing banks and check purchasers against society's interest in having cashier's checks function as viable cash substitutes. Commentators have generally favored the interests of banks and purchasers, thus inferentially supporting amendments that would permit the assertion of all claims to or defenses against cashier's checks in the possession of one who is not a holder in due course.[170] Their disagreement with the value judgment made by the *National Newark* line of cases—that cashier's checks should be treated as cash equivalents—is apparently based on the assumption that cashier's checks serve only two functions: providing a single transaction checking account much like a personal money order, and assuring the holder of a solvent obligor. Because these commentators apprehend that the primary purpose of the Code is to provide a means for equitable, after-the-fact resolution of disputes arising from commercial transactions, they fail to appreciate the cost savings that would be generated if the Code permitted more certainty in the planning of commercial transactions.

One reason for this diversity of opinion between courts and commentators is that the latter envision the model transaction as one involving a consumer sale in which a fly-by-night operator, requiring payment by cashier's check, takes advantage of an unprotected and ignorant consumer.[171] Viewing the transaction from the point where the dispute eventually arises rather than from the point where the check was initially negotiated, they reason that the parties deserving protection are the de-

170. *See* Wallach, *supra* note 23, at 597; Note, *supra* note 5, at 439; Note, *Adverse Claims and the Consumer: Is Stop Payment Protection Available?, supra* note 23, at 926.

171. *See generally* authorities cited in note 170 *supra*.

frauded purchaser and the normally unconcerned stakeholder, the bank. The commentators would protect the bank by permitting it to pay the proceeds of the disputed check into court.[172] The purchaser, in turn, would be protected by allowing him to litigate his defenses prior to the dissipation of the funds by the holder.

There are several serious problems with the commentators' position. First, subjecting holders to the purchasers' or the banks' defenses deprives cashier's checks of their independent function in commercial transactions: serving as a cash substitute. The possibility that holders in due course may be required to commence lawsuits simply to establish their right to payment will discourage them from accepting cashier's checks. This disincentive is even stronger when the holder has not dealt with the purchaser, and would not otherwise be subject to any suit based on the underlying transaction asserted by the purchaser. The only protection offered to the holder of a cashier's check, then, would be the assurance of a solvent obligor. Even this protection could be withdrawn, however, if the consideration received by the bank fails. Cashier's checks so perceived would serve no independent purpose in transactions where the holder is unconcerned about the purchaser's solvency, or wishes to shift the risk of the lost use of funds to the purchaser. This is ironic since these considerations are central to most transactions in which cashier's checks are currently used.

A second problem with the commentators' position is that few cashier's check transactions involve unethical sellers taking advantage of unwary consumers. On the contrary, most involve bargained-for exchanges in which the purchaser of the check, often a business, gives up its right to use an ordinary check (on which it could stop payment) in exchange for receiving a lower price, or as a precondition to the other party's participation. If cashier's checks are not permitted to serve as cash substitutes, the parties to commercial transactions will be deprived of a valuable bargaining tool. There is no reason to destroy a commercially useful cash substitute simply because some consumers have been mistreated in transactions involving it. Such abuses do not arise from the use of the cashier's checks per se, but from the fraudulent nature of the underlying

172. *See* Fox, *supra* note 23, at 695-96; Note, *supra* note 5, at 440-41; Comment, *Uniform Commercial Code—Stop Payment Orders—Cashier's and Teller's Checks*, 23 N.Y. L. SCH. L. REV. 518 (1978).

transaction. Effective consumer protection, then, should attack the real evils of that transaction, such as misrepresented products or inadequate disclosure, rather than the neutral commercial instrument used to finalize the transaction.

The better position, therefore, calls for amending the Code in a way that ensures that cashier's checks will serve as substitutes for cash. Guaranteeing cash equivalency for cashier's checks would require that holders take them free from all claims and virtually all defenses. These instruments then could offer both the finality of payment associated with cash and the security from loss provided by specially indorsed instruments. More specifically, the Code should be amended to provide that a holder of a cashier's check takes the instrument free from all defenses of the bank, and from all claims—both legal[173] and equitable—and defenses of all other parties except for the defenses of alteration and forged indorsement. Since instances of alteration are rare, this exception would detract very little from the cash equivalence of the instrument. The other risk that would still be incurred by the recipients of cashier's checks is that their check may bear a forged indorsement. Since a forged indorsement would mean that the bearer of the instrument would not be considered a holder,[174] the issuing bank would be under no duty to pay on the check. These two defenses are necessary to ensure that cashier's checks serve their second function: protecting against the risks of theft and of other losses that inhere in the use of cash.

This sort of amendment, of course, would require that banks exercise more restraint in issuing cashier's checks, since they will be liable even if the consideration given for a check fails. If a bank wishes to accommodate a customer by issuing a check prior to receiving consideration, it must gauge the goodwill it generates by premature issuance against the risk of loss it incurs. Under these amendments, banks will also be less likely to use cashier's checks as their own personal checks.

173. It is open to question whether one who is not a holder in due course should take free of legal claims of ownership. The interest in preserving the cash-like nature of cashier's checks certainly militates in favor of limiting the risks that must be incurred by a recipient of a cashier's check. On the other hand, if cashier's checks are to have any advantage over cash, their recipients should assume at least the risk that each indorsement is genuine. *See* note 24 *supra*.

174. U.C.C. § 3-404(1) provides that a forged signature is inoperative and, under U.C.C. § 1-201(20), a holder is a person who is in possession of an instrument indorsed to him. Thus, if there is a forged indorsement in a recipient's chain of title, he cannot be a holder of the instrument.

Banks that desire to reserve control over their checks, perhaps by the right to stop payment, should instead use teller's checks.[175] Finally, the proposed change would force purchasers of cashier's checks to exercise more discretion. They should use these instruments only when they are willing to give up the right to stop payment.[176] The Code, thus amended, could educate purchasers about the possible drawbacks of using cashier's checks by requiring that cashier's checks carry a warning that their use will foreclose the purchaser from stopping payment or raising any defenses.

This approach to amending the Code limits the ways in which banks and purchasers may preserve the proceeds of cashier's checks as funds from which they may satisfy claims arising from underlying transactions. Thus, if the party against whom a claim or defense exists has transferred the check in a nonfraudulent conveyance, the subsequent holder will take the check free of any claim[177] or defense. If, on the other hand, the original holder retains the check, the bank and the purchaser each have certain remedies. In most jurisdictions, if the bank has dealt with the holder, the local rules of civil procedure will permit the bank to raise its claims in the form of a counterclaim to the holder's action for payment.[178] The purchaser, although denied this remedy, will often have the ability to attach[179] or garnish[180] the check, thus enabling him to litigate

175. *See* notes 244-278 *infra* and accompanying text.

176. U.C.C. § 4-403(1), which codifies the common law rule, provides that "[a] customer may by order to his bank stop payment of any item payable for his account." The common law rule and some of the costs associated with it are examined in Horner, *The Stop Payment Order*, 2 BAYLOR L. REV. 275 (1950); Moore, Sussman & Brand, *Legal and Institutional Methods Applied to Orders to Stop Payment of Checks*, 42 YALE L.J. 817 (1933); Morrison & Sneed, *Bank Collections: The Stop-Payment Transaction—A Comparative Study*, 32 TEX. L. REV. 259 (1954); Note, *Stopping Payment of Checks*, 79 BANKING L.J. 185 (1962); Note, *Stop Payment and the Uniform Commercial Code*, 28 IND. L.J. 95 (1952).

177. Absent a fraudulent conveyance, the plaintiff cannot attach an instrument unless the defendant has an interest in it. Reich v. Spiegel, 208 Misc. 225, 140 N.Y.S.2d 722 (Sup. Ct. 1955); *see* Smith v. Amherst Acres, Inc., 42 A.D.2d 1038, 348 N.Y.S.2d 616 (1973). In County Nat'l Bank v. Inter-County Farmers Coop. Ass'n, 65 Misc. 2d 446, 317 N.Y.S.2d 790 (Sup. Ct. 1970), the court held that an assignment in good faith and for value had priority over the claim of a creditor of the assignor where the lien of the creditor had not been perfected before the assignment.

178. *See* note 61 *supra* and accompanying text.

179. *See, e.g.*, N.Y. CIV. PRAC. LAW § 5201(b) (McKinney 1978). California limits attachment to actions against business entities or the business assets of individuals. CAL. CIV. PROC. CODE § 483.010(c) (West 1979). Missouri limits the grounds for attachment to 14 specific cases involving mainly fraudulent conveyances and nonresident defendants. MO. REV. STAT. § 521.010 (1969). Several states require the party seeking attachment to post a bond indemnifying the

his claims before the holder can dissipate the funds. Enacting these amendments would allow cashier's checks to become effective cash substitutes and simultaneously facilitate the use of the Code as an aid in planning commercial transactions.[181]

IV. CERTIFIED CHECKS

A. THE NATURE OF CERTIFIED CHECKS: PRE-CODE TREATMENT

A certified check is a personal check that has been accepted by the drawee bank.[182] Banks may certify a check at the request of either its holder or its drawer. By accepting or "certifying"[183] a check, the bank undertakes the acceptor's contractual obligation to pay the check according to its terms at the time of its acceptance.[184] In consideration for undertaking this liability, the bank can immediately debit the drawer's account for the amount of the check.

Certified checks have been used in this country for over 130

holder from losses resulting from wrongful attachment. *See, e.g.*, CAL. CIV. PROC. CODE § 489.210 (West 1979); ILL. ANN. STAT. ch. 11, § 4(a)-(b) (Smith-Hurd 1963); N.Y. CIV. PRAC. LAW § 6212(b) (McKinney Supp. 1977). Others require that a debt represented by a negotiable instrument can be attached only by levy on the person in possession of the instrument. *See, e.g.*, CAL. CIV. PROC. CODE § 488.400(a) (West 1979); N.Y. CIV. PRAC. LAW § 5201(c)(4) (McKinney 1978); Standard Factors Corp. v. Manufacturers Trust Co., 182 Misc. 701, 50 N.Y.S.2d 10 (Sup. Ct. 1944), *aff'd*, 269 A.D. 658, 53 N.Y.S.2d 461 (1945); Finn v. National City Bank, 36 N.Y.S.2d 545 (Civ. Ct. N.Y. 1942). In cases involving cashier's checks, the Code could establish a special procedure that would permit attachment of a cashier's check after a bond indemnifying the holder from damages for wrongful attachment had been posted.

180. Garnishment will provide only limited protection, however, because of the constraints imposed on the right to garnish. *See, e.g.*, Fuentes v. Shevin, 407 U.S. 67 (1972) (requiring pregarnishment hearing). *But see* Mitchell v. W.T. Grant Co., 416 U.S. 600 (1974). *See also* North Georgia Finishing, Inc. v. Di-Chem, Inc., 419 U.S. 601 (1975).

181. If the U.C.C. is not amended to deny banks and purchasers the right to raise claims and defenses against one who is not a holder in due course, it should at least be amended to protect such holders from the unjustified assertion of claims and defenses. The U.C.C. could require that prior to the assertion of an adverse claim, the third-party claimant must indemnify not only the bank, but also the holder for his costs and attorney's fees should the claim be unsuccessful. This requirement would at least protect a holder in due course from having to expend unreimbursed sums merely to prove his entitlement to the proceeds of the check. *See* Note, *supra* note 5, at 442; Comment, *supra* note 134, at 815-16.

182. H. BAILEY, BRADY ON BANK CHECKS § 10.1 (5th ed. 1979).

183. "Certification of a check is acceptance . . . ." U.C.C. § 3-411(1).

184. U.C.C. § 3-410(1) provides that "[a]cceptance is the drawee's signed engagement to honor the draft as presented," and U.C.C. § 3-413(1) provides that "[t]he maker or acceptor engages that he will pay the instrument according to its tenor at the time of his engagement."

years,[185] but in recent years their use has steadily decreased because of the rise of computerized check processing systems. Certified checks cannot be easily processed through these computer systems,[186] so banks now use cashier's checks, which can be easily processed, whenever possible. Nevertheless, certified checks continue in use due mostly to various statutes that call for them.[187]

An understanding of the common law treatment of certified checks is essential to an appreciation of the Code's deficiencies with respect to these instruments. Under pre-Code law, the legal consequences of check certification differed greatly depending on whether certification had been procured by the drawer or the holder.[188] Holders normally had personal checks certified in lieu of receiving final payment in cash. Although banks were under no obligation to certify checks[189] for holders, they occasionally did so for a fee.[190] Under pre-Code law, this type of certification involved two distinct transactions: the holder's cashing of the drawer's personal check, and the holder's purchasing of the certifying bank's check or note.[191] After certification was obtained, the holder looked to the bank for payment, and the drawer was released from liability both on the check and on the underlying obligation.[192] The drawer lost his right to stop payment on the check once it was certified and the bank could no longer raise any of the drawer's defenses as a

185. *See* Steffen & Starr, *A Blue Print for the Certified Check*, 13 N.C. L. REV. 450, 450 n.2 (1935).

186. For a discussion of the problems banks encounter in processing certified checks through computerized check processing systems, see H. BAILEY, *supra* note 182, § 10.1; Windsor, *The Certified Check: A Special Handling Item in Automation*, 81 BANKING L.J. 480 (1964).

187. Some statutes require that only certified checks can be substituted for cash. *See, e.g.*, ARIZ. REV. STAT. ANN. § 45-1835(B) (1956) (bids for irrigation districts); PA. STAT. ANN. tit. 71, § 1636 (Purdon 1962) (bids for public printing and binding). Courts have held that the use of cashier's checks does not constitute compliance with statutes of this type. *See* Perry v. West, 110 N.H. 351, 353-54, 266 A.2d 849, 851-52 (1970); State *ex rel.* Babcock v. Perkins, 165 Ohio St. 185, 187-89, 134 N.E.2d 839, 842-43 (1956); Bowie County v. Farmers' Guar. State Bank, 289 S.W. 451, 452-53 (Tex. Civ. App. 1926). *But see* Hornung v. Town of W. New York, 82 N.J.L. 266, 267, 81 A. 1116, 1116 (Sup. Ct. 1911). *See also* Lord, *Certified Checks and Funds Redirection*, 24 VILL. L. REV. 28, 30 (1978).

188. Roberts & Morris, *The Effect of a Stop Payment Order on a Certified Check*, 5 WYO. L.J. 170, 172 (1951).

189. Wachtel v. Rosen, 249 N.Y. 386, 164 N.E. 326 (1928); H. BAILEY, *supra* note 182, § 10.2.

190. *See* H. BAILEY, *supra* note 182, § 10.2.

191. *See id.* § 7.6.

192. *See id.* § 10.8; Roberts & Morris, *supra* note 188, at 172; Steffen & Starr, *supra* note 185, at 457.

basis for rescinding certification.[193]

The common law regarding drawer-procured certification recognized that it was obtained for substantially different reasons than holder-procured certification. Normally, a drawer would obtain certification for the purpose of adding a bank's name to his own credit, thus encouraging the payee to accept a check instead of cash.[194] The subsequent negotiation of the check was not treated as a cash payment from the drawer to the holder, since courts treated the certifying transaction as simply adding the bank's liability to that of the drawer—much like the cumulative liability of a guarantor of a promissory note.[195] The drawer remained liable on both the check and the underlying obligation.[196] In some states, the drawer could stop payment on a certified check, and, so long as the check was not held by a holder in due course, the bank could raise any of the drawer's claims or defenses as grounds for rescinding its certification.[197] Thus, the holder of a certified check often received merely the security of a more financially secure obligor. Moreover, the drawer often retained the ability to shift the risks of litigation and of the loss of the use of funds to the holder despite the certification.

The fact that banks could raise drawers' defenses whenever certification had been procured by a drawer conflicted sharply with the public's impression of certified checks as cash equivalents.[198] Some commentators questioned whether this treatment would undermine public confidence in certified checks and weaken the instrument's capacity to serve as a cash substitute.[199] In apparent response to these criticisms, the draftsmen of Articles 3 and 4 altered the common law rule. Certification, whether procured by the drawer or the holder, was made the equivalent of final payment.[200] As a result, draw-

193. *See* Roberts & Morris, *supra* note 188, at 175; Steffen & Starr, *supra* note 185, at 457. If, however, a bank has certified the check by mistake and thus has a defense of its own, the certification can be rescinded so long as the holder has not changed position in reliance on the certification. H. BAILEY, *supra* note 182, at § 10.11.

194. *See* Roberts & Morris, *supra* note 188, at 172.

195. *Id.* at 173. *See also* Steffen & Starr, *supra* note 185, at 468.

196. *See* H. BAILEY, *supra* note 182, § 10.8; Roberts & Morris, *supra* note 188, at 173.

197. *See* H. BAILEY, *supra* note 182, § 20.10; Roberts & Morris, *supra* note 188, at 182-83; Steffen & Starr, *supra* note 185, at 458.

198. *See* Roberts & Morris, *supra* note 188, at 180; Steffen & Starr, *supra* note 185, at 476.

199. *See* authorities cited in note 198 *supra*.

200. U.C.C. § 3-418, which governs both certification and payment of checks,

ers were denied the right to issue stop payment orders even when certification was drawer-procured.[201] Also, banks were prohibited from rescinding certification except where, under the same circumstances, they could have recovered monies paid by mistake.[202] The only common law distinction retained in the Code was that the drawer is released when the holder has obtained certification, but not when the drawer himself has procured it.[203]

Unfortunately, these provisions fell short of remedying the deficiencies in the common law, and certified checks today remain unsuitable as cash substitutes. The Code's treatment of certification as analogous to final payment is an insufficient incentive for taking a certified check in lieu of cash. The risk of litigation still rests on the check holder. Furthermore, a transferee of a certified check, who has not even dealt with the party attempting to raise defenses against the check, takes subject to this risk. By imposing such risks on holders of certified checks and their transferees, the Code burdens the use of certified checks with substantial costs that do not occur when payment is in cash. If certified checks are ever to serve as cash substitutes, the Code must be amended to eliminate these counterproductive costs.

B. The Effect of Certification: Current Treatment of Certified Checks

Under the Code, a bank that has certified a check is liable to the holder unless the bank has a right to rescind its certification.[204] Section 3-418 sets forth the standard for determining

see U.C.C. § 3-411(1), appears to make certification final whenever payment would be final. *But see* notes 211-214 *infra* and accompanying text.

201. U.C.C. § 4-303(1)(a).

202. *Id.* § 3-418. *See* note 200 *supra.*

203. U.C.C. § 3-411(1). Even this distinction was eliminated in the May 1941 draft of the Code. *See* STATE OF NEW YORK, REPORT OF THE LAW REVISION COMMISSION FOR 1955: STUDY OF THE UNIFORM COMMERCIAL CODE 1034 (1955). Drawer liability was thought to be unnecessary because upon certification the drawer "lost control over the funds and the right to stop payment," and because certification is generally procured by the party "who finds it more convenient to visit the bank." *Id.* This change from the common law treatment drew the criticism that holders might not be satisfied with having only the bank's obligation. *Id.* In the final draft, however, the distinction was retained. The continued retention of this distinction, simply because of speculation that holders may not be satisfied with banks as sole obligors, is highly questionable in light of the extraordinary infrequency of bank insolvencies. *See* note 19 *supra.* Any U.C.C. amendment treating certified checks as cash equivalents should be accompanied by an amendment abolishing this distinction.

204. U.C.C. §§ 3-413(1), -418.

when certification is final: certification 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."[205] This section codifies the doctrine of *Price v. Neal*,[206] a case which held that a payor bank cannot recover payment made on a check bearing a forged drawer's signature. Section 3-418 also sets forth the general rule that in the absence of a breach of a presenter's warranty,[207] a bank cannot rescind its certification when certification is deemed final.[208]

Unlike the provisions of sections 3-305 and 3-306 for parties to ordinary negotiable instruments,[209] section 3-418 does not provide a comprehensive scheme governing the rights of the parties to certified checks. Section 3-418 thus has one fundamental deficiency: it describes the situation in which a bank may not rescind certification—when certification is deemed final—but it fails to describe the situations in which a bank may rescind because certification is not final.[210]

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205. The text of U.C.C. § 3-418 is quoted in note 45 *supra*.

206. 3 Burr. 1354, 97 Eng. Rep. 871 (1762).

207. U.C.C. § 3-417(1) enumerates the presenter's warranties that are made to the payor bank by any person who obtains acceptance or payment of a check. *See also* U.C.C. § 4-207(1). Under U.C.C. § 3-418, there is an exception to finality for the recovery of bank payments as provided in Article 4. This exception is limited, however, to provisional payments made under U.C.C. § 4-301.

208. For purposes of applying the doctrine of Price v. Neal, 3 Burr. 1354, 97 Eng. Rep. 871 (1762), acceptance is treated as the equivalent of payment. Thus, the drawee may not cancel its certification when the holder has in good faith changed position in reliance on the certification. *See* Admiral Leather Corp. v. Manchester Modes, Inc., 422 F. Supp. 387 (S.D.N.Y. 1976); Kansas Bankers Sur. Co. v. Ford County State Bank, 184 Kan. 529, 338 P.2d 309 (1959). *But see* Rockland Trust Co. v. South Shore Nat'l Bank, 336 Mass. 74, 314 N.E.2d 438 (1974). *See generally* Note, *Finality of Payment and the Uniform Commercial Code*, 32 TEMP. L.Q. 182 (1959).

209. U.C.C. §§ 3-305 and 3-306 list the claims and defenses to which holders of negotiable instruments are subject, and the persons who may raise these claims and defenses.

210. A second deficiency is that although U.C.C. § 4-303(1)(a) makes it clear that a drawer has no right to issue a stop payment order once a check has been certified, section 3-418 fails to indicate whether the drawer or a third party may, by asserting an adverse claim, compel the bank to refuse payment. In the case of ordinary negotiable instruments, U.C.C. § 3-305(1) provides that a holder in due course takes free of the claims of any party, and U.C.C. § 3-306(a) provides that one who is not a holder in due course takes subject to all valid claims of ownership of any person. There are no similar provisions in the U.C.C. that settle this issue for certified checks. In the absence of guidance from the Code, courts generally have allowed both drawers and third parties to assert adverse claims whenever certification is not final. *See* Admiral Leather Corp. v. Manchester Modes, Inc., 422 F. Supp. 387 (S.D.N.Y. 1976); Jefferies & Co. v. Arkus-Duntov, 357 F. Supp. 1206 (S.D.N.Y. 1973); Rockland Trust Co. v. South Shore Nat'l Bank, 336 Mass. 74, 314 N.E.2d 438 (1974); Balducci v. Merchants Nat'l Bank & Trust Co., 74 Misc. 2d 406, 345 N.Y.S.2d 263 (Sup. Ct. 1972), *aff'd*

1. *When Certification is Final*

Certification is final in favor of holders in due course.[211] For persons who do not enjoy this status, it is not clear whether section 3-418 should be read literally to limit the benefits of finality to those who have changed position in reliance on the *payment* of the check, or whether it should be read broadly to confer these benefits on persons who have changed position in reliance on *certification* as well. Once a bank has paid on a certified check, there is no longer a question of whether it has the ability to defeat its obligation to pay; instead, the question becomes whether payment was final. Thus, a literal reading of section 3-418 effectively limits its protection to holders in due course.

Although both the literal and nonliteral interpretations have support in case law,[212] reason and history favor the nonliteral approach, which would extend the protection of section 3-418 to those who have changed position in reliance on certification. Under common law, certification was final in favor of all persons who changed position in good faith and in reliance on it,[213] and it does not appear that the draftsmen intended to alter this rule. Furthermore, a rule that limits finality of certification to holders in due course would result in a senseless incongruity between the treatment accorded persons receiving final payment in cash and those who obtain certification in lieu of cash. For example, if a seller of goods waited until he cashed

mem., 41 A.D.2d 1030, 344 N.Y.S.2d 828 (1973); Lincoln Sec. v. Morgan Guar. Trust Co., 8 U.C.C. Rep. Serv. 215 (N.Y. Sup. Ct. 1970). Before enactment of the U.C.C., courts were similarly liberal in permitting the assertion of third-party claims. *See, e.g.*, Greenberg v. World Exch. Bank, 227 A.D. 413, 237 N.Y.S. 200 (1929); Llop v. First Nat'l Bank, 178 Misc. 436, 35 N.Y.S.2d 867 (Sup. Ct. 1942).

211. Some of the questions encountered in the earlier discussion of whether the holder of a cashier's check who has notice of the drawer's defenses is still a holder in due course, *see* notes 101-109 *supra* and accompanying text, also present themselves here. Because the drawer is released from liability upon certification procured by the holder, the drawer's defenses on the underlying transaction would not appear to be defenses to the instrument, and notice of them would not affect the holder's status. Of course, when certification is procured by the drawer himself, he is not released, and his defenses on the underlying transaction would then be defenses to the instrument. Therefore, they would constitute notice to the holder under U.C.C. § 3-302(1)(c).

212. Both Admiral Leather Corp. v. Manchester Modes, Inc., 422 F. Supp. 387 (S.D.N.Y. 1976), and Balducci v. Merchants Nat'l Bank & Trust Co., 74 Misc. 2d 406, 345 N.Y.S.2d 263 (Sup. Ct. 1972), *aff'd mem.*, 41 A.D.2d 1030, 344 N.Y.S.2d 828 (1973), have interpreted U.C.C. § 3-418 to make certification final as to those who have changed position in reliance on the certification. However, Rockland Trust Co. v. South Shore Nat'l Bank, 336 Mass. 74, 314 N.E.2d 438 (1974), limits the finality of certification to holders in due course.

213. *See generally* authorities cited in note 197 *supra*.

a check before releasing goods to the buyer, the seller would be able to retain the money as against the bank if the buyer subsequently brought an action against the seller based on the sale.[214] Yet the same seller would lose in his action for payment against the bank if he had demanded that the check be certified, or if he had originally demanded payment by a certified check, since the bank could then justifiably refuse payment by raising the buyer's defenses.

Despite the fact that the nonliteral interpretation of section 3-418 is more rational, two serious problems arise when the benefits of finality are extended to those who have changed position in reliance on certification: one is the difficulty of applying the ambiguous reliance standard, and the other is that the results reached under this interpretation seem inconsistent with other provisions of the Code. Under the Code, as at common law, where the holder has procured the certification, the drawer is released from liability on both the check and on the underlying obligation. If the holder is not a holder in due course, and has not changed position in reliance upon the certification, the bank may rescind its certification simply by asserting that it has not received adequate consideration from the drawer. This would leave the holder without recourse on the instrument, since the drawer has already been released,[215] and without a claim capable of overcoming the bank's defense against the check.

A strong argument can be made that the release of the drawer is in and of itself a change of position sufficient to make certification final.[216] A problem with this argument, though, is that every time the holder has had a check certified, the certification would be final. Thus, the language of the section would be largely superfluous.[217] There is a similar problem surround-

214. *See* First Nat'l City Bank v. Altman, 3 U.C.C. Rep. Serv. 815 (N.Y. Sup. Ct. 1966).

215. It must be kept in mind that the drawer is released only when the holder obtains certification. U.C.C. § 3-411(1). *See also* note 203 *supra* and accompanying text. The drawer remains liable on both the check and the underlying obligation if he himself has obtained certification.

216. It is not clear whether the fact that the holder has lost his cause of action against the purchaser on the underlying transaction under U.C.C. § 3-802(1) constitutes a change of position for purposes of U.C.C. § 3-418. Although there are no post-U.C.C. cases, certain prior cases considered the same question involving holder-procured certification and held the discharge of the drawer to be a sufficient change of position. Times Square Auto. Co. v. Rutherford Nat'l Bank, 77 N.J.L. 649, 73 A. 479 (1909); Fiss Corp. v. National Safety Bank & Trust Co., 191 Misc. 397, 77 N.Y.S.2d 293 (Civ. Ct. N.Y. 1948).

217. Another argument which might be made is that the holder is not considered to have changed position, but that the purchaser's liability is reinstated

ing the questions of whether section 3-418's good faith requirement serves only to qualify the holder's action in having the check certified, or whether it further refers to the holder's honesty in conducting the underlying transaction with the drawer.[218] Unless this good faith requirement is interpreted to refer only to the holder's actions in obtaining certification, a holder who knew of a minor defense to payment would be denied the benefits of finality of certification even though the drawer, who was released from liability by the certification, would have had only a partial defense to payment.[219] None of these problems are present when the drawer rather than the holder has procured the certification, though, because then the drawer remains liable to the holder.[220]

2. *When Certification is Not Final*

Certification is not final when the holder is not a holder in due course, or has not changed position in reliance on the certification. Section 3-418 does not indicate which claims or defenses a bank may raise to successfully rescind on those occasions when its certification is not final. As they have done with respect to cashier's checks, courts for public policy reasons could simply have denied banks the right to rescind certification, even when it was not final under section 3-418. Such an approach would certainly have contributed to the cash equivalency of certified checks. But, instead, courts have been uniform in permitting banks to rescind certification whenever it

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on the underlying transaction. In certain pre-U.C.C. cases in which the drawee certified the check despite either insufficient funds in the drawer's account or a stop payment order issued by the drawer, it was held that since the drawer created the situation, he was not released on the check or underlying obligation. *See, e.g.*, Condenser Serv. & Eng'r Co. v. Mycalex Corp., 7 N.J. Super. 427, 71 A.2d 404 (Super. Ct. Law Div. 1950); Baldinger & Kupferman Mfg. Co. v. Manufacturers' Citizens' Trust Co., 93 Misc. 94, 156 N.Y.S. 445 (Sup. Ct. 1915); Plantation's Bank v. Desormier, 102 R.I. 565, 232 A.2d 371 (1967).

218. U.C.C. § 1-201(19) defines good faith as "honesty in fact in the conduct or transaction concerned."

219. For instance, a car dealer might have relinquished possession of a car in reliance on the receipt of the drawer's check, even though the car dealer knows of a defense of the drawer (*e.g.* the auto's defective condition). Suppose that the drawer has insufficient funds in his account, the bank certifies the check for the holder by mistake, and the holder is unaware of the bank's mistake. If the holder's dishonesty in his transaction with the drawer means that his change of position in reliance on the certification was not in good faith, he will lose not only his cause of action against the drawer, U.C.C. § 3-802(1), but also his cause of action against the bank, even though the drawer has only a partial defense to payment.

220. *See* U.C.C. §§ 3-411(1), -802(1); note 203 *supra* and accompanying text.

is not final.[221] Courts have disagreed, however, on the precise grounds that justify permitting banks to rescind, and two distinct theories have been advanced. One theory applies Code section 3-306. In *Rockland Trust Co. v. South Shore National Bank*,[222] the court held that if certification is not final under section 3-418, then the rights of a holder of a certified check are governed, as in all other cases involving holders who are not holders in due course, by section 3-306. Under section 3-306, a bank can raise any of its defenses and any of the drawer's legal claims of ownership, although the bank may not raise the drawer's mere defenses. If the bank wishes to assert the drawer's equitable claims of ownership, section 3-306 requires that the drawer defend the action for the bank.[223]

The second and more generally accepted theory[224] disregards the Code and looks instead to common law.[225] Under the common law approach, banks have been permitted to rescind against holders who are not holders in due course and who have not changed position in reliance on the certification, whenever the bank has a defense of its own,[226] or there is a third party who has a claim of ownership,[227] or the drawer has a defense arising out of the underlying transaction in which he negotiated the instrument.[228] Some of these courts have gone

221. *See generally* note 210 *supra*.

222. 336 Mass. 74, 314 N.E.2d 438 (1974).

223. *See* notes 122-146 *supra* and accompanying text.

224. *See, e.g.*, Admiral Leather Corp. v. Manchester Modes, Inc., 422 F. Supp. 387 (S.D.N.Y. 1976); Jefferies & Co. v. Arkus-Duntov, 357 F. Supp. 1206 (S.D.N.Y. 1973); Balducci v. Merchants Nat'l Bank & Trust Co., 74 Misc. 2d 406, 345 N.Y.S.2d 263 (Sup. Ct. 1972), *aff'd mem.*, 41 A.D.2d 1030, 344 N.Y.S.2d 828 (1973); Lincoln Sec. v. Morgan Guar. Trust Co., 8 U.C.C. Rep. Serv. 215 (N.Y. Sup. Ct. 1970).

225. *See* Admiral Leather Corp. v. Manchester Modes, Inc., 422 F. Supp. 387 (S.D.N.Y. 1976); Balducci v. Merchants Nat'l Bank & Trust Co., 74 Misc. 2d 406, 345 N.Y.S.2d 263 (Sup. Ct. 1972), *aff'd mem.*, 41 A.D.2d 1030, 344 N.Y.S.2d 828 (1973); Lincoln Sec. v. Morgan Guar. Trust, 8 U.C.C. Rep. Serv. 215 (N.Y. Sup. Ct. 1970). All these cases refer to the pre-U.C.C. case of Greenberg v. World Exch. Bank, 227 A.D. 413, 237 N.Y.S. 200 (1929), and the *Lincoln* opinion also refers to another pre-U.C.C. case, Llop v. First Nat'l Bank, 178 Misc. 436, 35 N.Y.S.2d 867 (Sup. Ct. 1942).

226. Although none of the common law cases cited in note 227 *infra* involved a bank raising its own defenses, this situation presents the strongest case for permitting a bank to rescind certification.

227. *See* Jefferies & Co., Inc. v. Arkus-Duntov, 357 F. Supp. 1206 (S.D.N.Y. 1973); Balducci v. Merchants Nat'l Bank & Trust Co., 74 Misc. 2d 406, 345 N.Y.S.2d 263 (Sup. Ct. 1972), *aff'd mem.*, 41 A.D.2d 1030, 344 N.Y.S.2d 828 (1973); Lincoln Sec. v. Morgan Guar. Trust Co., 8 U.C.C. Rep. Serv. 215 (N.Y. Sup. Ct. 1970).

228. *See* Admiral Leather Corp. v. Manchester Modes, Inc., 422 F. Supp. 387 (S.D.N.Y. 1976).

even further than the common law. Pointing to the Code's erosion of the distinction between certification procured by drawers and by holders,[229] at least one court has allowed a bank to rescind certification on account of a drawer's claim even though the certification was holder-procured. This rule has the effect of releasing the drawer from liability both on the check and on the underlying obligation.[230]

A classic example of the liberality with which rescission of nonfinal certification has been allowed under the common law theory is *Admiral Leather Corp. v. Manchester Modes, Inc.*[231] In *Admiral*, the drawer had purchased certain goods from the payee with a personal check. The payee later procured certification, thus releasing the drawer from liability both on the contract and on the check. Upon discovering that the goods were nonconforming, the drawer requested that the bank refuse payment on the check. The bank agreed after the drawer had undertaken to indemnify it for the costs of the defense. By that time the drawer had already commenced its own action against the payee for breach of warranty. Notwithstanding the fact that the drawer had initiated a separate suit on the underlying transaction, the court permitted the bank to rescind certification if the payee could not show that it had changed position in reliance upon the certification. By thus consolidating the drawer's action against the payee and the payee's action against the bank, the court in effect permitted the bank to raise the drawer's mere defenses on the underlying transaction.

Since a bank is not obligated to honor its acceptor's contract when payment is not final, a bank may refuse to pay on the check, and may interplead the drawer and the holder whenever the drawer has a claim to or a defense against the check.[232] Moreover, if the holder brings an action against the bank for its voluntary refusal to pay, it appears that the drawer may intervene.[233] If the bank is unwilling to refuse payment on

229. *See* Balducci v. Merchants Nat'l Bank & Trust Co., 74 Misc.2d 406, 345 N.Y.S.2d 263 (Sup. Ct. 1972), *aff'd mem.*, 41 A.D. 2d 1030, 344 N.Y.S.2d 828 (1973) (court permitted drawer to assert its claim of ownership even though holder had procured certification).

230. *See* Balducci v. Merchants Nat'l Bank & Trust Co., 74 Misc. 2d 406, 345 N.Y.S.2d 263 (Sup. Ct. 1972), *aff'd mem.*, 41 A.D. 1030, 344 N.Y.S.2d 828 (1973).

231. 422 F. Supp. 387 (S.D.N.Y. 1976).

232. *See* Balducci v. Merchants Nat'l Bank & Trust Co., 74 Misc. 2d 406, 345 N.Y.S.2d 263 (Sup. Ct. 1972), *aff'd mem.*, 41 A.D. 1030, 344 N.Y.S.2d 828 (1973); Lincoln Sec. v. Morgan Guar. Trust Co., 8 U.C.C. Rep. Serv. 215 (N.Y. Sup. Ct. 1970).

233. Although the question of intervention does not appear to have been presented in any case, the court in Admiral Leather Corp. v. Manchester

a check when the holder is subject to third-party claims, under either the common law or the Code theory, the drawer or another third party may assert an adverse claim of ownership.[234] In *Jefferies & Co. v. Arkus-Duntov*,[235] the court granted the drawer's request to enjoin payment to one who was not a holder in due course while simultaneously refusing to enjoin payment to a holder in due course. Once it is acknowledged that one who is not a holder in due course is subject to third-party claims of ownership,[236] decisions such as *Jefferies* are clearly compelled.[237]

The case law therefore reaches results that are for the most part consistent with the apparent intent of the draftsmen of the Code—that the effects of nonfinal certification be the same as those resulting from nonfinal payment. In the case of nonfinal payment, banks have an equitable right to restitution of monies paid by mistake.[238] By analogy, then, when a bank has been fraudulently induced to certify a check, or when it has certified a check on the mistaken belief that the drawer's account contained sufficient funds, the bank should also have an equitable right of restitution. And, if a third party has a claim of ownership which it asserts after certification, it appears that since a bank may not obtain discharge under section 3-603(1), it would

Modes, Inc., 422 F. Supp. 387 (S.D.N.Y. 1976), consolidated the holder's action against a bank and the drawer's action against the holder on the underlying obligation.

234. The Code theory requires that the adverse claimant either obtain an injunction against payment or indemnify the bank. U.C.C. § 3-603(1).

235. 357 F. Supp. 1206 (S.D.N.Y. 1973).

236. If the holder's title to the instrument is subordinate to the claim of ownership of the third party, U.C.C. § 3-603(1) seems applicable. This section permits third parties to assert adverse claims.

237. Under the majority view, since a bank may defeat payment to the holder by asserting the drawer's mere defense, *see* text accompanying note 228 *supra*, there is a question of whether the drawer can enjoin the bank from paying the holder when the drawer is only asserting a defense to payment based on the underlying obligation. Certainly, if section 3-306(d) were applied, the injunction would fail since under that section the bank may raise only the drawer's claims, and not his defenses. In addition, the bank is not in need of protection in this situation, since it could obtain a discharge simply by paying the holder, even with notice of the drawer's defense. *See* U.C.C. § 3-603(1). But this does not necessarily resolve the question of whether a court should enjoin a bank from paying a check under such circumstances. A strong argument can be made that unless injunctions are available where the drawer has a defense, banks can arbitrarily determine whether the drawer or holder bears the loss. This argument is even more appealing considering the fact that since the drawer would be a party to the action, there would be no danger of inconsistent results.

238. *See* Note, *The Doctrine of Price v. Neal under Articles Three and Four of the Uniform Commercial Code*, 23 U. PITT. L. REV. 198, 198-215 (1961).

need an equitable right to raise this claim. But the consistency between the case law and the draftsmen's intent disappears when the drawer attempts to assert his own defense to payment. Here, the bank's payment of a certified check would not expose it to liability under section 3-603(1), nor could the bank argue that it certified the check by mistake. Thus, based on analogy to actions premised on the equitable right of restitution, it appears that cases like *Admiral*, which in effect permit banks to raise the mere defenses of the drawer, are erroneous. Although application of section 3-306 would produce somewhat similar results, the better analysis of the nonfinal certification problem would be accomplished by way of reference to nonfinal payment, not reference to section 3-306.

C. The Current Utility of Certified Checks

Both the common law and Code theories for determining when a bank may rescind certification generate too many potential costs for holders to allow certified checks to serve as viable cash substitutes. There is a definite discrepancy between the view expressed by some courts that certified checks are cash substitutes, and the risks that these same courts are willing to impose upon the checks' holders. The case of *Jefferies & Co. v. Arkus-Duntov*,[239] in which the same result would have been reached under either the common law or Code theory, is instructive. In *Jefferies*, the court enjoined payment to one who was not holder in due course, and refused to enjoin payment to a holder in due course, reasoning:

> Aside from the requirements of the Uniform Commercial Code, equity should, for policy reasons, refrain from interfering with the free flow of commerce. The integrity of the certified check is a valuable asset in our economy. An innocent holder should not be disturbed in his rightful possession, though the result may mean a windfall for the customer whose loan has been repaid by the questionable means described.[240]

In *Jefferies*, the court failed to realize that permitting a third party to enjoin payment when a certified check is held by one who is not a holder in due course, or allowing the bank to raise its own or the drawer's defenses under those same circumstances, destroys the "integrity" of certified checks. Furthermore, the court's decision forced the payee bank, which was ultimately found to be a holder in due course, to expend substantial time and money in judicially establishing that fact. Despite its success in court, therefore, the bank realized an

239. 357 F. Supp. 1206 (S.D.N.Y. 1973).
240. *Id.* at 1217.

amount substantially less than if it had simply required payment in cash.

The inefficiency caused by *Jefferies* is obvious. First, the payee bank was not a party to the transaction in which the third party's defenses arose. Thus, if the bank had been paid in cash, it would have incurred no expenses whatsoever, and, of course, could not have been made party to an action arising from the underlying transaction. Since it took a certified check, however, the payee bank was forced into litigation. Second, regardless of whether the payee bank was subject to an action by a third party based on the underlying transaction, the court's decision to permit a third party to enjoin payment and to allow the drawee bank to raise the drawer's or its own defenses unnecessarily shifts the costs of instituting litigation to the holder in addition to depriving him of the use of funds during litigation. Shifting the burden of commencing litigation to holders may actually increase the frequency of banks' willingness to refuse payment. Indeed, if a bank were under the impression that the holder might not be protected by section 3-418, it would be good business for the bank to refuse payment and force the holder to commence an action establishing his right to payment. No penalty would be assessed against the bank for its actions, yet the bank would gain substantial bargaining power for persuading the holder to settle at an amount lower than the face value of the check.

Because of these risks, holders should instead require payment either by cash or by cashier's check, since courts almost uniformly deny banks the right to defeat payment on cashier's checks.[241] This situation raises the question of what role remains for certified checks. Since certain statutes require their use, certified checks still serve a purpose,[242] albeit limited. In addition, certified checks do provide a more solvent obligor than do uncertified checks. Yet if banks are permitted to rescind certification whenever they have a defense, this protection is certainly diluted.

Considering that banks are phasing out the use of certified checks and replacing them with cashier's checks,[243] perhaps the courts and the draftsmen of the Code should simply assume that certified checks will fade out of use. But if legislatures and the public continue to demand that certified checks

241. *See* cases cited in note 47 *supra*.
242. *See* note 187 *supra*.
243. *See* H. BAILEY, *supra* note 182, § 10.1.

be used in lieu of cash, the Code should provide for this role. Because of the Code's explicit provisions concerning finality of certification, courts cannot treat certified checks in the same manner as they treat cashier's checks. Consequently, if certified checks are to remain in use, the Code should be amended to give to the holders of certified checks the same protection that most courts accord the holders of cashier's checks.

V. TELLER'S CHECKS

A. THE NATURE OF TELLER'S CHECKS

Teller's checks are checks drawn by a bank—usually a savings and loan association—upon a commercial bank.[244] Teller's checks serve two functions: they are used as personal checks by savings and loan associations, and are used as cash equivalents by purchasers of the checks. The present uses of teller's checks thus parallel those of cashier's checks. Since savings and loan associations cannot provide checking services, they must use teller's checks drawn upon commercial banks in situations where commercial banks would simply issue their own cashier's checks.[245]

The Code treats teller's checks as if they were ordinary personal checks, regarding the fact that the drawer is a bank as merely incidental. The drawer bank has the obligation to pay the amount of the check upon receipt of any necessary notice of dishonor.[246] The drawee bank, on the other hand, is not liable until it accepts the check.[247] The drawer bank has the right to stop payment on the check,[248] since it is a customer of the drawee bank.[249] The drawer bank may exercise this right when it has a defense arising out of the issuance of the check, or simply as an accommodation to the purchaser of the teller's check if the purchaser has a claim or defense arising from his negotiation of the instrument.[250] If the drawer bank will not voluntarily stop payment on the check at the purchaser's request, the

244. *See* Note, *supra* note 31, at 524.

245. Both federal and state law prohibit savings and loan associations from engaging in checking accounts. *See, e.g.*, 12 U.S.C.A. § 1464(b)(1) (West Supp. 1979); CAL. FIN. CODE § 5003 (West Supp. 1979); N.Y. BANKING LAW §§ 378-383 (McKinney Supp. 1979).

246. U.C.C. § 3-413(2).

247. *Id.* § 3-409(1).

248. *Id.* § 4-403(1).

249. *Id.* § 4-104(e).

250. The purchaser of a teller's check has no right to order payment stopped. Under U.C.C. § 4-403(1), a customer may stop payment only on an "item payable for his account." A teller's check is for the account of the drawer

purchaser may still retard payment by asserting an adverse claim.[251]

When a teller's check is dishonored by the drawee bank, the holder must sue the drawer bank on its obligation under section 3-413(2). Against a holder in due course, a bank may defeat payment only if it has a real defense or if it has a personal defense and has dealt with the holder.[252] If the holder is not a holder in due course, the bank may raise any of its own defenses and any legal claims of ownership of third parties.[253] It may also raise the equitable claims of a third party if that party defends the action for the bank.[254] The bank, however, may not raise the mere defenses of a third party.[255]

Even though the Code manifests an apparent intention to treat teller's checks as personal checks,[256] it is doubtful whether the two distinct functions[257] that the business community assigns teller's checks were considered when this decision was made. If teller's checks were in fact used merely as the personal checks of drawer banks, it would be entirely proper to give drawer banks the rights of any other drawer of an ordinary negotiable instrument. If, however, teller's checks are to serve as cash substitutes as well, it is improper to give drawer banks the same protection accorded drawers of ordinary personal checks. This protection simply imposes too many risks on holders of teller's checks for the checks to have any semblance of cash equivalency.

Courts have recognized the problems created by the dual function of teller's checks:[258]

> The plaintiff accepted a [teller's check] as in the nature of cash. This is a procedure that is widely followed in business transactions of many varieties throughout this area . . . . A teller's check has generally been treated as "cash." . . . It seems to me that the defense urged by the defendant would be applicable only where the bank issuing the teller's check is an actual party to a transaction.

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bank, not for the purchaser/remitter. *See also* U.C.C. § 4-403, Official Comment 5.

251. U.C.C. §§ 3-603(1), -306(d).
252. *Id.* § 3-305(2).
253. *Id.* § 3-306(b) to (d).
254. *Id.* § 3-306(d).
255. *See* text accompanying note 130 *supra*.
256. *See* U.C.C. §§ 4-104(e), -403(1).
257. *See* text accompanying notes 244-245 *supra*.
258. *See, e.g.*, Manhattan Imported Cars, Inc. v. Dime Sav. Bank, 70 Misc. 2d 889, 335 N.Y.S.2d 356 (App. Term 1972); Rubin v. Walt Whitman Fed. Sav. & Loan Ass'n, 21 U.C.C. Rep. Serv. 610 (N.Y. Sup. Ct. 1977); Meckler v. Highland Falls Sav. & Loan Ass'n, 64 Misc. 2d 407, 314 N.Y.S.2d 681 (Sup. Ct. 1970); Ruskin v. Central Fed. Sav. & Loan Ass'n, 3 U.C.C. Rep. Serv. 151 (N.Y. Sup. Ct. 1966); Malphrus v. Home Sav. Bank, 44 Misc. 2d 705, 254 N.Y.S.2d 980 (Sup. Ct. 1965).

> For example, if the defendant savings bank were engaged in a contract for the purchase of property, equipment, etc., it would be regarded as the actual obligor in the transaction and could stop payment if it discovered fraud or a question arose as to the consideration, etc., in the same manner as any individual could stop payment. Here, however, the defendant savings bank, in effect, sold an instrument which was used exactly as one might use cash or a certified check. The defendant savings bank was in no sense a party to the transaction between the plaintiff and [the person who paid with the teller's check].[259]

In an attempt to reconcile the dual functions of teller's checks, the courts of New York have consistently denied drawer banks the right to raise any claims or defenses of third parties,[260] while at the same time permitting banks to raise their own defenses whenever they could do so if the check were regarded as an ordinary personal check.[261] Of course, allowing a drawer bank to raise its own defenses when the check is being used by the purchaser in the nature of cash renders even this treatment of teller's checks inadequate to preserve true cash equivalency.

In fact, it is impossible to devise a set of rules that can completely reconcile both functions of teller's checks. The very characteristics that must be present in order for a drawer bank to have the same rights as the drawer of an ordinary personal check are the ones that destroy the ability of teller's checks to serve as cash substitutes. One of these two contradictory functions should be selected for teller's checks, and the Code should specifically assure that function. Since cashier's checks serve primarily as cash substitutes, it is sensible to designate teller's checks as the personal checks of banks. An advantage of this approach is that no amendments would be necessary, since the Code already treats teller's checks in this fashion. If this course were taken, however, the courts, the public, and even banks would have to be reeducated, since many of them currently consider teller's checks as cash equivalents similar in nature to cashier's checks.

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259. Malphrus v. Home Sav. Bank, 44 Misc. 2d 705, 706-07, 254 N.Y.S.2d 980, 982-83 (Sup. Ct. 1965).

260. *See* Manhattan Imported Cars, Inc. v. Dime Sav. Bank, 70 Misc. 2d 889, 335 N.Y.S.2d 356 (App. Term 1972); Meckler v. Highland Falls Sav. & Loan Ass'n, 64 Misc. 2d 407, 314 N.Y.S.2d 681 (Sup. Ct. 1970); Ruskin v. Central Fed. Sav. & Loan Ass'n, 3 U.C.C. Rep. Serv. 151 (N.Y. Sup. Ct. 1966); Malphrus v. Home Sav. Bank, 44 Misc. 2d 705, 254 N.Y.S.2d 980 (Sup. Ct. 1965).

261. *See* Rubin v. Walt Whitman Fed. Sav. & Loan Ass'n, 21 U.C.C. Rep. Serv. 610 (N.Y. Sup. Ct. 1977); Smith v. New York Bank for Sav., 11 U.C.C. Rep. Serv. 1210 (N.Y. Sup. Ct. 1973).

B. The Bank's Right to Raise the Purchaser's or Its Own Claims and Defenses

There are two separate lines of decisions dealing with the issue of whether a drawer bank should be permitted to raise the purchaser's claims or defenses against a teller's check. One applies Code section 3-306(d),[262] while the other views teller's checks as cash equivalents and flatly denies banks the right to raise any claims or defenses of the purchaser.[263]

Under the first line of cases, if the holder brings a suit against the drawer bank, the bank may raise third-party claims of ownership but may not raise third-party defenses.[264] In *Fulton National Bank v. Delco Corp.*,[265] the drawer bank, at the request of the purchaser, ordered the drawee bank to stop payment on a teller's check. The court allowed the drawer bank to raise the purchaser's equitable claims of ownership.[266] In justifying its application of section 3-306(d) to this problem, the *Fulton* court noted the section's technical applicability,[267] and added that allowing all claims to be adjudicated in one action would avoid a multiplicity of suits.[268]

A correlate to the application of section 3-306(d) is the ability of third-party claimants to assert adverse claims under section 3-603(1). Although the Code permits third parties to assert adverse claims, it is not clear what procedural steps they must take in order to comply with section 3-603(1). For instance, in the case of a promissory note, a claimant must assert his claim against the maker who, in turn, seeks a discharge by paying the

262. *See* Fulton Nat'l Bank v. Delco Corp., 128 Ga. App. 16, 195 S.E.2d 455 (1973).

263. *See* cases cited in note 260 *supra*.

264. *See* notes 122-130 *supra* and accompanying text.

265. 128 Ga. App. 16, 195 S.E.2d 455 (1973).

266. It should be noted that the purchaser was a party to the action.

267. In holding that the bank's liability on a teller's check is governed by U.C.C. § 3-306(d), the *Fulton* court distinguished teller's checks, which it held to be mere orders from the drawer bank to the drawee bank, from cashier's checks, which it held to be notes carrying an unconditional promise to pay. It also distinguished teller's checks from certified checks, which it held to be accepted drafts. 128 Ga. App. at 18, 195 S.E.2d at 456. Although this might be a proper literal application of the Code, it is interesting that the court was not disturbed by the fact that teller's checks and cashier's checks are functional equivalents.

268. 128 Ga. App. at 20, 195 S.E.2d at 457-58. The court's argument that permitting banks to raise the purchaser's claims avoids a multiplicity of suits is unpersuasive. Only in the instant case would an additional suit be avoided. Normally, if the court refused to permit the bank its right to raise the purchaser's claims, the bank would have no independent reason to refuse payment of a teller's check. Then, only one lawsuit would exist—that between the purchaser and the holder.

holder. The claimant's act of either indemnifying the maker or obtaining an injunction will deprive the maker of his ability to achieve discharge by paying the holder. In the case of a teller's check, however, the party seeking discharge is the drawer bank, while the party who must make the payment is the drawee bank. As a result, there is significant ambiguity regarding which party must be indemnified or enjoined.[269]

Application of sections 3-306(d) and 3-603(1) poses the same practical problems for teller's checks as it does for cashier's checks. On the one hand, the purchaser of a teller's check is given only limited protection: he may raise his claim of ownership, but not his defenses to payment. On the other hand, allowing even this limited protection seriously undermines the cash equivalency of teller's checks. Recognizing the Code's deleterious effect on the capacity of teller's checks to serve as cash substitutes, a line of decisions in New York has flatly rejected its applicability.[270] Beginning with the case of *Malphrus v. Home Savings Bank*,[271] the New York courts have attempted to guarantee teller's checks cash-equivalent status. In fact, these courts have succeeded to the extent that they disallow the assertion of all third-party claims and defenses.[272]

One problem with the New York decisions lies in the reasoning the courts have employed. The courts posit that because under section 3-802(1) the purchaser obtains a discharge on the underlying obligation when the holder receives the teller's check in payment of that obligation, it would be unfair to permit the drawer bank to raise the purchaser's defenses after he has been discharged.[273] This argument is unconvincing

269. *See* Note, *supra* note 31, at 545-46. It appears that the only logical reading of U.C.C. § 3-603(1) would require the remitter to assert an adverse claim to the drawer bank, which is the only party seeking discharge, and require the drawer bank to issue a stop payment order.

270. *See* cases cited in note 260 *supra*.

271. 44 Misc. 2d 705, 254 N.Y.S.2d 980 (Sup. Ct. 1965).

272. Finding, as these courts have, that all holders take teller's checks free from third-party claims of ownership means that there is no possibility of a third party ever having an adverse claim to assert under U.C.C. § 3-603(1). This result was noted in Ruskin v. Central Fed. Sav. & Loan Ass'n, 3 U.C.C. Rep. Serv. 150 (N.Y. Sup. Ct. 1966):

> It is clear that the defendant [drawer bank] is primarily liable to the plaintiff [holder] and is not a stakeholder besieged by adverse claimants since under the circumstances presented the bank could not be liable to its depositor [purchaser]. The rights of the depositor as against plaintiff on the underlying transaction should be determined in a separate lawsuit.

Id. at 152.

273. *See* cases cited in note 260 *supra*.

because allowing interposition of the purchaser's defenses does not treat the holder unfairly, but simply limits the holder's recovery. In other words, the purchaser would not be totally denied recovery against the bank. Rather, he would be denied recovery only to the extent that the purchaser's claim is valid. Under these decisions, even if the holder fully recovers against the bank, he would still be liable to the purchaser in a subsequent action for the same damages.[274]

Obviously, if teller's checks are to serve as cash equivalents, the Code must be amended. However, it is not likely that amending the Code to comport with the New York decisions—which merely disallow the assertion of third-party claims and defenses—would guarantee cash-equivalent status for teller's checks. The New York approach ignores the deleterious impact of continuing to allow the drawer bank to raise its own defenses.

Using teller's checks both as cash substitutes and as the personal checks of banks is impossible when banks can raise their own defenses to payment. If the party who originally received the teller's check from the bank still holds it, no real problem exists, since a bank may raise its own defenses against one with whom it has dealt even if the person accepted the check in the nature of cash. Moreover, the bank could raise its complaint as a counterclaim in the holder's action for payment.[275] But once the original recipient has transferred the check, insurmountable problems arise. The transferee may well have accepted the teller's check from the previous holder as if it were in the nature of cash, and with no knowledge of any irregularities in the transaction in which his transferor obtained the check. Permitting a bank to raise its own defenses against a transferee in this situation would have as potentially serious an impact upon cash equivalency as would permitting the bank to raise the purchaser's defenses. In both cases, the holder must bear the risk of litigation and the risk of loss of the use of the funds.[276]

Nevertheless, the courts, including those following *Mal-*

274. Even if the holder had not dealt with the purchaser and therefore would not otherwise have been subject to the purchaser's claims or defenses, the holder would still be made whole since he has a breach of warranty action against his transferor under U.C.C. § 3-417(2)(d), which provides that "no defense of any party is good against [the purchaser]."

275. *See* note 61 *supra* and accompanying text.

276. *See* notes 110-114 *supra* and accompanying text.

phrus,[277] look to sections 3-305 and 3-306 to determine whether a bank may raise its own defenses against a holder.[278] Under these sections, a bank may raise its own defenses against any holder except a holder in due course with whom it has not dealt. For example, in *Rubin v. Walt Whitman Savings & Loan Association*,[279] the court cited *Malphrus* with approval and allowed the bank to raise the defense, against a transferee of the purchaser, that the bank had by mistake issued a teller's check in the wrong amount. Although it is likely that the transferee took the check as a cash substitute, he found himself subject to the defense of the bank, despite his unawareness of and lack of responsibility for the defense. The tacit rationale for this treatment is that if courts deny banks the right to raise their own defenses, teller's checks cannot adequately serve as the personal checks of banks because the drawer bank would have no ability to defeat its obligation to pay.

C. A Proposed Role for Teller's Checks

It is imperative that some determination be made regarding the most efficient use of teller's checks. The Code could be amended so that teller's checks would function as cash substitutes. This would require substantial revisions, including one that would bar the drawer's right to assert its own defenses. Barring these defenses is a step, however, that even the courts following *Malphrus* have been unwilling to take. Amending the Code in this fashion would also result in a great deal of overlap between the functions of teller's checks and cashier's checks. It appears that teller's checks would be better utilized if they served only a single purpose—that of the personal checks of banks. The existence of such an instrument would permit banks to issue teller's checks instead of cashier's checks whenever they wish to retain the right to stop payment and to raise their own defenses. Furthermore, since the Code already treats teller's checks as the personal checks of the drawer bank, no revision of the Code would be required.

VI. CONCLUSION

The Uniform Commercial Code must provide a framework in which business transactions can be carried out in a cost-effective manner. Moreover, the rules governing negotiable in-

277. *See* text accompanying note 271 *supra*.
278. *See* cases cited in note 261 *supra*.
279. 21 U.C.C. Rep. Serv. 610 (N.Y. Sup. Ct. 1977).

struments should reflect careful value judgments regarding the most desirable role for each particular instrument, and should precisely define the rights and liabilities of the parties to the various types of checks and notes that circulate in our economy. Articles 3 and 4 fail to offer the comprehensive framework that the modern business community needs. The provisions of these articles too often treat negotiable instruments as a homogeneous group and fail to recognize the peculiar functions that our economy has assigned each separate instrument. This failure is most apparent with regard to the Code's treatment of bank checks.

Bank checks can potentially serve two important functions in the economy. Primarily, bank checks can be utilized as cash substitutes, offering the finality of payment in cash while at the same time insulating the transacting parties from the risk of loss. Additionally, bank checks can serve as the personal checks of banks. The Uniform Commercial Code totally ignores these two distinct roles of bank checks and therefore should be revised.

Since it is impossible for a single instrument to serve the conflicting roles of cash equivalent and personal check, the Code should explicitly assign only one role to each instrument. Cashier's checks should be clearly defined as cash equivalents, and teller's checks should continue to serve as the personal checks of banks. Certified checks, already obsolescent because of problems in processing, should be phased out of use altogether. Such revisions would lend more certainty to transactions involving commercial paper and would rationalize the functions of the bewildering variety of negotiable instruments that are available for use in modern commercial transactions.