



South Dakota Legislative Research Council

Issue Memorandum 94-23

OVERVIEW OF ARTICLES 3 AND 4 OF THE UNIFORM COMMERCIAL CODE

The National Conference of Commissioners on Uniform State Laws (NCCUSL), in conjunction with the American Law Institute (ALI), rewrote Articles 3 and 4 of the Uniform Commercial Code (UCC). The revised articles updated Article 3 for technological developments and changes in business practices, resolved divisions in authority, and modernized language. Article 4 was revised as necessary to conform to Article 3, and it was modernized for automated check processing and truncation.

The South Dakota Legislature adopted these revisions to Articles 3 and 4 of the UCC during the 1994 Legislative Session. House Bill 1296 contained the revisions to Article 3, which covers negotiable instruments. House Bill 1321 contained the revisions to Article 4, which deals with bank deposits and collections. Each has a delayed effective date of July 1, 1995.

Historical Perspective

NCCUSL is an organization composed of practicing lawyers, judges, law professors, and experts in legislative drafting appointed by their respective state governments to identify areas of state law needing uniform treatment among the states and to draft proposals to meet that end. Over a century ago, lawyers recognized the benefit of uniform laws, but it was not until the NCCUSL approached its fiftieth year that it launched the project that produced the UCC. Formerly, the NCCUSL approached problems one at a time. In 1940, however, it took on the

task of drafting an extensive package to provide comprehensive solutions for commercial transactions. In 1947 the NCCUSL and the ALI joined forces and produced the UCC, which was first offered to states in 1951. South Dakota enacted Articles 3 and 4 of the UCC in 1966, and these statutes became effective on July 1, 1967.

Much has changed in banking over the past forty years. The articles produced in 1951 were written for a payment system which was based on paper. The revised Articles 3 and 4, completed in 1990, are intended to clarify and modernize the law as well as recognize the impact of computers and electronic transactions in the modern banking environment.

What follows is an overview of the principal revisions of Articles 3 and 4 of the UCC. Please note that all citations refer to the law as passed by the 1994 Legislature, and the law at these citations will take effect July 1, 1995.

Article 3

Part 1. General Provisions and Definitions

Definitions

Definitions were added and amended. The revised UCC defines *good faith* as "honesty in fact and the observance of reasonable commercial standards of fair dealing." SDCL 57A-3-103(4). Previously, the UCC referred only to "honesty in fact." Also included is a definition of ordinary care which was not

defined in the prior Article 3. *Ordinary care* is defined as "observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged." SDCL 57A-3-103(7). This definition allows for automated procedures for examining checks, and this would not constitute failure to exercise ordinary care.

Negotiability

Several principals of negotiability were revised. Under the revised UCC a check is negotiable even if it does not satisfy the "payable to holder or bearer" requirement. SDCL 57A-3-103. This was changed so that a person could not scratch out the "pay to the order of" and, in so doing, destroy the negotiability of the instrument. Also, the particular fund doctrine was eliminated so that an instrument is negotiable even though payment is limited to a particular fund or source. SDCL 57A-3-106. Another important change is that an instrument with a variable rate of interest is negotiable even if reference to some outside source is required. SDCL 57A-3-112.

Statutes of Limitations

The revised Article 3 provides for statutes of limitations for certain kinds of instruments. SDCL 57A-3-118. For example, for promissory notes, the limit is six years after the due date, and for demand instruments, the limit is six years after demand for payment, with an overall maximum of ten years after the last payment of principal or interest. For drafts, the period is three years after dishonor or ten years after the date of the draft, whichever is first. The prior Article 3 did not include a provision regarding statutes of limitations.

Part 2. Negotiation, Transfer, and Indorsement

Indorsement

The revised Article 3 includes a definition of indorsement which includes all signatures made for negotiating the instrument, restricting payment on the instrument, and incurring liability on the instrument. SDCL 57A-3-204. The prior version did not define indorsement. In addition, the revised Article 3 eliminates the conditional indorsement. A conditional indorsement will be treated as a special indorsement with the condition disregarded. Restrictive indorsements, such as "for deposit only," are still recognized. SDCL 57A-3-206.

Part 3. Enforcement of Instruments

Holder in Due Course

The revised Article 3 clears up an ambiguity by stating that a person who accepts an instrument bearing "apparent evidence of forgery or alteration" or is "so irregular or incomplete as to call into question its authenticity" is not a holder in due course. SDCL 57A-3-302. Also, the revised Article 3 changes the time period after which the indorsee of a check will be denied holder in due course status from thirty days to ninety days. SDCL 57A-3-304.

Discharge on the Instrument or Obligation

The revised Article 3 also describes those situations which constitute a discharge on the instrument, the underlying obligation, or both. SDCL 57A-3-310. The prior Article 3 provided that "discharge of the underlying obligor on the instrument also discharges him on the obligation." Rather than such a sweeping statement, the revised version provides, in general, that if the creditor is in possession of a check or note, the creditor may sue on either the dishonored instrument or on the underlying obligation. If the

creditor has sold the instrument to a third party, the creditor may enforce either the instrument or the obligation. If the debtor transferred a third party instrument to the creditor, the debtor/indorser's liability would be only on the instrument.

Accord and Satisfaction

The law of accord and satisfaction as it pertains to checks bearing "in full payment" was revised. Creditors receiving many checks are not likely to notice such a notation, yet under prior law may have been held to an accord and satisfaction even when it was not their intention. The revised Article 3 states that there is no accord and satisfaction unless the following criteria are met: (1) the debtor was in good faith, (2) the amount of the claim was unliquidated or subject to dispute, and (3) the creditor obtained payment of the instrument. If these criteria are met, the debtor may be entitled to discharge if the debtor can prove the instrument or an accompanying notation contained a conspicuous statement that it was tendered in full satisfaction of the debt. SDCL 57A-3-311.

Part 4. Liability of Parties

Signature of a Representative

Under the revised Article 3, a representative can bind the principal on the instrument even if the representative signs his name only. SDCL 57A-3-401. This is in contrast to the prior Article 3 under which no person was liable on an instrument unless that person's signature was on the instrument. The revised version also provides that a representative who signs a check is not personally liable if the check indicates the name of the represented party. SDCL 57A-3-402.

Fictitious Payees

Under the prior Article 3, if an impostor impersonated the president of a corporation and was issued a check in the name of the corporation, the fictitious payee rule would not apply because it was not payable to the impostor personally. Under the revision, the rule would apply to this situation and to those situations in which the impostor was named as payee. SDCL 57A-3-404.

Fraudulent Indorsement of an Employee

The revised Article 3 added a new section making employers liable for the fraudulent indorsements of their employees if the employees had the authority to sign, indorse, prepare, or otherwise act with respect to the instruments in a representative capacity. SDCL 57A-3-405.

Allocation of Loss for Forgery or Alteration

The prior Article 3 precluded a negligent party from asserting forgery or alteration against a payor such as a bank who paid the instrument in good faith and in accordance with reasonable commercial standards. The bank was denied this defense if it failed to exercise ordinary care. The revision under Article 3 puts in place a comparative negligence system, so loss may be allocated between the two parties on this basis. SDCL 57A-3-406.

Cashier's Checks

Although the prior Article 3 permitted a bank to dishonor cashier's checks, teller's checks, and certified checks, the revised Article 3 requires banks to pay these instruments. They are treated essentially as cash equivalents. SDCL 57A-3-411.

Payment by Mistake

The revised Article 3 includes a section on dealing with problems created when instruments are paid by mistake. It permits

the recovery of payments made by mistake to anyone except a holder in due course or person in substantial reliance. SDCL 57A-3-418.

Part 5. Dishonor

Payment and Notice of Dishonor

The revised Article 3 eliminated the necessity of presentment as it related to the liability of secondary parties. Notice of dishonor is still required in order to hold secondary parties liable. Banks remain subject to the midnight deadline, but other parties now have thirty days to give notice, rather than three, as under prior law. SDCL 57A-3-503.

Part 6. Discharge and Payment

Indorsers and Accommodation Parties

The revised Article 3 deals with the situation in which a bank may allow the debtor an extension of time or otherwise change some condition in the contract. An accommodation party might claim discharge under suretyship law. While most instruments used by professional lenders include a waiver of the suretyship rights of secondary parties, the revised Article 3 applies to cases where there is no waiver by providing that discharge of a principal party does not discharge the accommodation party. It also provides that an extension or other kind of modification given to a debtor does not discharge the accommodation party unless harm can be shown. SDCL 57A-3-605.

Article 4

Part 1. General Provisions and Definitions

Definitions

Unlike prior Article 4, the revised Article 4 defines a bank. *Bank* is defined as "a person

engaged in the business of banking, including a savings bank, savings and loan association, credit union, or trust company." SDCL 57A-4-105. Today any of these institutions offer accounts upon which checks and other payment orders can be drawn, but only banks were clearly governed by the prior Article 4.

Electronic Presentment

Another significant change not part of the prior version is that the revised Article 4 allows for presentment of an item by means of an electronic image. SDCL 57A-4-110.

Statute of Limitations

Another new addition to the general provisions is that there is now a three-year statute of limitations where there was none before. SDCL 57A-4-111.

Part 2. Collection of Items: Depository and Collecting Banks

Collecting Bank as Agent

Displacing any uncertainty in the prior Article 4, the revised Article 4 provides that a collecting bank is an agent of the owner of the item, regardless of the form of the indorsement. SDCL 57A-4-201.

Depository Bank as Holder of Unindorsed Instrument

Further, the revised Article 4 provides that a depository bank is a holder of an item transferred to it by its customer, even if no indorsement appears on the instrument. SDCL 57A-4-205. This is in line with modern check handling practices.

Misencoding

The revised Article 4 provides that a depository bank warrants to any subsequent collecting bank that the information is correctly encoded. SDCL 57A-4-209. This applies to underencoding such as a \$225,000

item encoded for \$25,000 and to overencoding such as a \$84 check encoded for \$84,000.

Midnight Deadline

Consistent with the prior Article 4, a collecting bank may charge back the amount of an item against its customer's account if it notifies the customer within the midnight deadline or longer reasonable time. The revised Article 4 allows charge back even if notice is delayed longer; however, the collecting bank is liable for any loss resulting from the delay. SDCL 57A-4-214.

Process of Posting Eliminated

Another change regarding the collection of items is that references to posting are eliminated in the revised Article 4. Other means of making final payment were left unchanged, but posting was eliminated as not suitable for a system of automated check collection or electronic presentment.

Part 3. Collection of Items: Payor Banks

Cut-offs

The revised Article 4 allows a bank to establish "cut-offs" for checks, before which time a bank can honor an item even though it is subject to some legal process such as a court-ordered freeze of an account. SDCL 57A-4-303.

Part 4. Relationship Between Payor Bank and Its Customer

Post-dated Checks

A dramatic change from the prior version of Article 4 deals with post-dated checks. Under the prior Article 4, a post-dated check was deemed a time instrument, not payable until the indicated date. This placed a burden on banks since they were not able to physically examine each check. Under the revised

Article 4, a customer who wishes to post date a check must give written notice to the bank, describing the check with a reasonable degree of certainty. The notice is effective for six months. SDCL 57A-4-401.

Wrongful Dishonor

A payor bank is liable to its customer for failure to pay on an item which is properly payable. The prior version referred to mistake by stating that "when the dishonor occurs through mistake liability is limited to actual damages proved." This led to confusion in cases not alleging mistake. The revised Article 4 provides that "[a] payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item. Liability is limited to actual damages proved and may include damages for an arrest or prosecution of the customer or other consequential damages." SDCL 57A-4-402.

Truncation

The revised Article 4 authorizes a descriptive bank statement to facilitate truncation. Banks are permitted to supply only the item number, amount, and date of payment. SDCL 57A-4-406. With this, a bank is able to send electronic information, rather than the check itself, which saves time and money.

Customer's Duty to Discover--Allocation of Loss

Under prior Article 4, a customer was expected to examine his bank statements and report any forgeries to the bank within fourteen days. If the customer did not do so, the customer could be liable for subsequent forgeries or alterations by the same wrongdoer. On the other hand, the bank was not permitted to rely on the fourteen-day rule if the customer was able to establish a lack of ordinary care on the part of the bank. The revised Article 4 changed this rule. SDCL 57A-4-406. First, the time period was

extended to thirty days. Secondly, the doctrine of comparative negligence was adopted so that if both parties were at fault the loss would be allocated between them. Finally, the bank is held to the duty of ordinary care as defined in Article 3. By this, automated procedures are approved. Therefore, if a bank can prove that its customer failed to examine his statement and put the bank on notice of the possibility of future problems, the bank would not have to share the loss solely because it adopted an automated system of

collection or payment.

Summary

In Article 3, some of the new provisions are simply definitions such as *banks* and *ordinary care*. Other provisions make important changes in the law regarding negotiability, accord and satisfaction, and agent's signatures. The changes in Article 4 deal with balancing the rights of the customers with the obligations of the banks. Together the revisions to Articles 3 and 4 of the UCC update these important pieces of legislation for current banking practice and technology.

This issue memorandum was written by Jacquelyn Storm, Senior Legislative Attorney for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.

