To: **Commission**

From: John Cannel

Re: **UCC Articles 3 and 4**

Date: **6/10/2013**

In 2002, the Permanent Editorial Board of the Uniform Commercial Code approved changes to Article 3 (Negotiable Instruments) and Article 4 (Bank Deposits). These amendments have been adopted in only 10 states and the District of Columbia. The only commercial state to adopt them is Texas. Banking interests have never endorsed them, and there has been declining interest in their enactment over the years. Enactment of these changes is no longer a priority for the Uniform Law Commission. In addition, there is some concern that the changes that were intended to deal with new technology may now be made problematic by later changes in technology.

The Uniform Law Commission explanation of the changes is:

> Articles 3 and 4 were extensively revised and amended in 1990 and 1991. Article 3 was fully revised and Article 4 was updated by timely amendments. In 2002, these articles continue to provide efficient rules governing negotiable instruments and checks. But a decade of experience plus some changes in the transactional environment require some modest amendments:
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> 1. To alleviate bad case law respecting bankruptcies, an amendment makes it clear that a person which has acquired ownership of an instrument directly or indirectly from a person entitled to enforce it when loss of possession occurred, may enforce the lost instrument. This solves a problem for the FDIC and others involved in transactions involving pooled instruments.
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> 2. An amendment makes it clear that payment of an instrument to the person identified as the person with the power to enforce the instrument is discharged, even if the instrument has been transferred to another person who actually has the current power to enforce, until the person required to pay is notified of the transfer. Under current law, if a borrower's loan was transferred from one bank to another, and the borrower makes a payment to the first bank, the borrower may be obligated to make an identical payment to the second bank even though the first bank has received payment, if the second bank is a holder of the instrument in due course. Under the amendment to UCC §3-602, this situation would not arise. The second bank is deemed to have notice of the payment to the first bank if that payment was made before the borrower received adequate notification of the transfer of rights under the negotiable note.
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> 3. A new phenomenon is telephonically generated checks, in which the consumer authorizes a check to be issued in his or her name over the telephone to pay an obligation. There are general warranties of transfer in both Articles 3 and 4 that facilitate the transfer of negotiable instruments and specifically checks. No existing warranty applies to these "remotely-generated consumer items (checks)." The warrantor is the customer or bank that transfers the check for settlement (payment). That person warrants that the "item" is authorized for the amount for which the item is drawn.

4. The rules of suretyship are updated to conform to the recent Restatement of Suretyship. A surety guarantees or assumes payment. Indorsers and "accommodation parties" are examples of sureties in negotiable instruments law. They assume obligations of payment by signing negotiable instruments that may be affected by discharge other than by payment to the persons who may enforce such instruments. The issue addressed in Articles 3 and 4 is what effect such a discharge has upon the obligations of the surety? When are those obligations discharged? Old Article 3 generally discharged the obligations of indorsers and accommodation parties to the extent that the drawer/maker of the instrument was discharged, while retaining any right of recourse for loss that the indorser or accommodation party might suffer against the drawer or maker of the instrument. Old Article 3 also dealt with the effect of impairment of collateral associated with an instrument by the person entitled to enforce the interest. Generally, indorsers and accommodation parties were discharged from their secondary obligations to the extent of the impairment of collateral.

The amendments change the terminology to principal obligor and secondary obligor, consistent with the Restatement. When there is a discharge of primary obligor, the rights of a secondary obligor are more clearly and certainly provided for in the amendments. Any obligation of a primary obligor to a secondary obligor based on prior payment on the instrument remains unaffected. If recourse against the primary obligor is not reserved in a release by a party able to enforce the instrument, there is no recourse against the primary obligor after release. To the extent that a secondary obligor is not discharged when the primary obligor is discharged, the secondary obligor is discharged to the extent of any consideration given by the primary obligor and to the extent that the secondary obligor has a loss as a result of the primary obligor's discharge. Generally, extensions of time, specifically, to the primary obligor are extensions of time to the secondary obligor. If there is impairment of collateral, the secondary obligor has discharge to that extent, paralleling the old rule for indorsers and accommodation parties.

The conclusion from these changes is that scope is increased to the extent that secondary obligor is a broader term than indorser and accommodation party. Obligees and primary obligors have greater flexibility in reorganizing obligations, but cannot do so to the detriment of secondary obligors.

5. There are several requirements that certain documents be in writing. The amendments convert the term "writing" or "written" to "record," consistent with the Uniform Electronic Transactions Act. Electronic records, therefore, meet these statute of frauds requirements. However, the amendments do not authorize electronic negotiable instruments or checks.

6. The FTC has disclosure statement requirements that apply to instruments in consumer transactions. An amendment makes it clear that the omission of these required statements is not a defense against enforcement of an instrument under Article 3. An amendment also provides in Article 3 that applicable consumer law conflicting with Article 3 preempts conflicting Article 3 rules.

These rules contribute to the continued efficiency of transactions involving negotiable instruments and payment by checks. Every state needs to enact these amendments.

The New Jersey Law Revision Commission has never published a Report on these UCC amendments. While the Commission normally considers and reports on UCC amendments, the effects of the passage of time militate against consideration of these amendments at this time.