UCC Bulletin

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When the Official Text of Uniform Commercial Code Article 3 (Negotiable Instruments) was revised in 1990,[1] one of the more significant and, according to some commentators, controversial changes was an expanded definition of good faith. Before the 1990 revision, good faith for purposes of Article 3, including that necessary to qualify as a holder in due course, required that a party act with "honesty in fact in the conduct or transaction concerned". That definition was construed by the vast majority of courts as creating only a subjective standard under which good faith existed if the party acted with a "pure heart." It was sometimes said that this subjective standard accommodated the rapid negotiation and collection of negotiable instruments, particularly checks, and that "[t]he wheels of commerce would grind to a halt" if an objective standard of good faith was employed. *See e.g., Bowling Green, Inc. v. State St. Bank & Trust Co.,* 425 F.2d 81, 85 (1st Cir. 1970).

Revised Article 3 retained "honesty in fact" in its definition of good faith while adding an objective component requiring the "observance of reasonable commercial standards of fair dealing". Good faith for holder in due course status under Revised Article 3 thus requires that the "pure heart" be accompanied by conduct that, as described by one court, reflects an "avoidance of advantage-taking." *See State Bank of the Lakes v. Kansas Bankers Surety Co.*, 328 F.3d 906, 909 (7th Cir. 2003). As a result, "the paramount necessity of unquestioned negotiability has given way, at least in part, to the desire for reasonable commercial fairness in negotiable transactions." *See Maine Family Fed. Credit Union v. Sun Life Assur. Co. of Canada,* 727 A.2d 335, 344 (Me. 1999).

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Holder in due course

Holder in due course status protects those innocent holders[2] who receive a negotiable instrument[3] with no reason to suspect that it "is not as sound as its face would indicate". *Unico v. Owen,* 232 A.2d 405, 417 (N.J. 1967). A holder in due course thus takes the instrument free of any claim thereto by another party, including that of a prior secured party. *See* UCC §§ R3-306 and R9-339. It also takes free of any defenses that exists to the instrument's enforcement other than the so-called "real defenses".[4] *See* UCC § R3-305(b) and Official Comment 1. These protections, however, may be superseded by laws outside of Revised Article 3, such as those applicable to consumer transactions. *See* UCC § R-3-302(g) and Official Comment 7. In addition, a party liable under the instrument (an obligor) may assert those defenses that arose after a holder in due course took the instrument, such as a defense that the holder in due course itself discharged the instrument by cancellation. *See* UCC § R3-604.

Because a holder in due course often benefits at the expense of an innocent party (i.e., one who otherwise has valid claims or defenses to the instrument), Revised Article 3 imposes strict requirements upon a holder seeking such status. Whether or not those requirements have been satisfied will not be determined unless and until an obligor raises and submits proof of a claim or a defense to the instrument's enforcement that is not available against a holder in due course. *See* UCC § R3-308(b). The holder will then have the burden of establishing its due course status by showing that it took the instrument (a) for value (b) in good faith and (c) without notice: (i) that the instrument was overdue, had been dishonored or that there had been any uncured default with respect to the payment of another instrument issued as part of the same series; (ii) that instrument contained any unauthorized signatures or had been altered; or (iii) of any claim or defense to the instrument. *See* UCC § R3-302(a)(2).[5]

Definition of good faith

The former Article 3 did not define good faith, but instead looked to the definition of "honesty in fact in the conduct or transaction concerned" then found in UCC Article 1. *See* UCC § 1-201(19). Consistent with other UCC Articles, Revised Article 3 defined good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing". *See* UCC § R3-103(a)(4) and Official Comment 4. Recent amendments to the Official Text of Articles 1 (in 2001) and Revised Article 3 (in 2002), have incorporated this definition in Article 1 and removed it from Article 3. *See* UCC §§ R1-201(a)(20) and AR3-103. As a result, a uniform definition of good faith now applies throughout the UCC's Official Text, with the exception of UCC Article 5. *See* UCC § R1-201, Official Comment 20.

Subjective good faith

"Honesty in fact" has been construed by most courts as creating a subjective standard of good faith that looks to a holder's actual intent or state of mind. *See In re Joe Morgan, Inc.*, 985 F.2d 1554 (11th 1993); *Community Bank v. Ell,* 564 P.2d 685 (Ore. 1977). Under this standard, good faith requires that a holder have taken the instrument without "actual knowledge of or participation in any material infirmity in the original transaction (*see Kaw Valley State Bank & Trust Co. v. Riddle,* 549 P.2d 927, 933 (Ka. 1976)) or "a belief based upon the facts and circumstances as known to [it] that there was a defense" to the instrument (*see In re SGE Mortg. Funding Corp.*, 278 B.R. 653,663 (Bank. M.D. Ga. 2001)). A holder therefore acts with subjective good faith if it "did not have actual knowledge of some fact which would prevent a commercially honest individual from taking the instrument". *See Chemical Bank of Rochester v. Haskell,* 411 N.E.2d 1339, 1341 (N.Y. 1980).

Subjective good faith in general imposes neither a duty of care nor a duty to investigate upon a holder when taking an instrument. *See Third Nat'l Bank v. Handi-Gardens Supply of Ill., Inc.*, 380 F.Supp 930 (M.D. Tenn. 1974); *General Inv. Corp. v. Angelini*, 278 A.2d 193 (N.J. 1971). Constructive knowledge cannot be imputed to a holder for purposes of assessing its subjective good faith and it is of no consequence what a reasonable person in the holder's position would have known or would have been led to inquire about concerning the instrument or its underlying transaction. *See In re Apponline.com, Inc.,* 285 B. R. 805 (Bank. E.D.N.Y. 2003). While the holder's suspicions alone do not negate its subjective good faith, a holder cannot intentionally fail to act on those suspicions so as to remain ignorant of facts which it believes or fears would disclose a defense or claim to the instrument. *See Ell,* 564 P.2d at 691.

Inasmuch as it requires only that the holder "honestly believed that there was nothing wrong" (*see Financial Management Services, Inc. v Famalian, Corp.,* 25 UCC Rep Serv. 2d 1237 (Ariz. App. 1995)), the subjective good faith standard has been described as "protecting the objectively stupid so long as he is pure of heart". *See Seinfeld v. Commercial Bank & Trust Co.*, 405 So.2d 1039, 1042 (Fla. App. 1981). Although the holder bears the initial burden of proof as to its good faith, that burden as to subjective good faith has been described as "slight." *See First International Bank of Israel, Ltd. v. L. Blankstein & Son, Inc.*, 452

N.E.2d 1216, 1218 (N.Y. 1983). An affidavit or the oral testimony by the holder attesting to its subjective good faith usually suffices to shift the burden to the obligor to offer evidence to the contrary. *See e.g., Triffin v. Dillabough*, 670 A.2d 684 (Pa. Super. 1996), aff'd, 716 A.2d 605 (Pa. 1996). As it usually will be difficult for an obligor to show what the holder actually knew or believed, the shifted burden in most cases will be "substantial". *See Fidelity Bank N.A. v. Avrutick,* 740 F. Supp. 222, 236 (S.D.N.Y. 1990).

In the vast majority of those cases where a holder has been denied due course status because of its lack of subjective good faith, the basis of that finding was that the holder took the instrument with actual knowledge of a claim or defense to it. *See Hawkland & Lawrence UCC Series [Rev.]* § 3-302:10 (2003). Subjective good faith has also been found lacking where the holder had knowledge of the obligor's financial difficulty (*see First Federal Sav. & Loan Ass'n v. Chrysler Credit Corp.,* 981 F.2d 127 (4th Cir. 1992)); a close-connection with the instrument's underlying transaction sufficient to charge it with knowledge of any infirmity to it (*see Midfirst Bank v. C.W. Haynes & Co.,* 893 F.Supp. 1304 (D.S.C. 1994), aff'd unpubl. op., 87 F.3d 1308 (4th Cir. 1996)); or exchanged value for the instrument substantially less than its face amount (*see First City Federal Sav. Bank v. Bhogaonker*, 684 F. Supp. 793 (S.D.N.Y. 1988)).

Objective good faith

The "observance of reasonable commercial standards of fair dealing"[6] is generally accepted to create an objective standard that measures the fairness of the holder's actions. *See e.g., San Tan Irrigation Dist. v. Wells Fargo Bank,* 3 P.3d 1113 (Ariz. App. 2000); *but see Halla v. Norwest Bank Minn., S.A.*, 601 N.W.2d 449 (Minn. App. 1999) (holding that under Minnesota law both prongs of good faith are measured by a subjective test). While the contours of "fair dealing" are neither specified nor defined in Revised Article 3, the Official Comments did offer some guidance as to what it requires of a holder:

> Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely different concept than failure to deal fairly in conducting the transaction. Both fair dealing and ordinary care, which is defined in [Revised] Section 3-103(a)(7), are to be judged in the light of reasonable commercial standards, but those standards in each case are to be directed to different aspects of commercial conduct.

UCC § R3-103, Official Comment 4.

The Maine Supreme Court has identified a two-part test for determining a holder's objective good faith. *See Maine Family Fed. Credit Union,* 727 A.2d at 335. Under this test, it is necessary for the holder to show both that its conduct comported with industry or commercial standards applicable to the transaction and that those standards were reasonable standards intended to result in fair dealing. Each of those determinations must be made within the context of the specific transaction at issue. "Thus, a holder may be accorded holder in due course status where it acts pursuant to those reasonable commercial standards of fair dealing—even it if it negligent—but may lose that status, even where it complies with commercial standards, if those standards are not reasonably related to achieving fair dealing." *Id.*

Application of objective standard

Revised Article 3, like the former Article 3, denies holder in due course to a holder who acquired the instrument without subjective good faith. The issue of a holder's objective good faith will therefore normally not arise until its subjective good faith has been established. It is perhaps for this reason that to date not many reported decisions have addressed the issue of a holder's objective good faith.

Some cases suggest that the burden as to the holder's lack of objective good faith is ultimately upon the party against whom the instrument is being enforced. This approach is illustrated by *Stebbins v. Georgia Power Co.,* 555 S.E.2d 906 (Ga. App. 2001), where the holder, a utility company, was alleged to have acted in bad faith when it unknowingly accepted forged checks in payment of corporate utility bills. The checks had been drawn on the account of a 93-year old woman who had no relationship with the billed companies. In response to an action by the drawer's guardian to recover the amounts paid under the forged checks, the utility company submitted an affidavit by its employer that recited that those checks had been received in the ordinary course of business and without notice of any irregularity, and had been accepted by the utility company in good faith. The appellate court agreed with the trial court that because the drawer's guardian failed to offer any evidence in support of its allegations of bad faith, the utility company's affidavit was sufficient to establish its good faith under Revised Article 3 to qualify as a holder in due course. *See Stebbins,* 555 S.E.2d at 906-908; *see also Cadle Co. v. Ginsburg*, 721 A.2d 1246 (Conn. App. 1998), (finding that the "evidence overwhelmingly established" the holder's subjective and objective good faith and that the defen-

dant had not provided any credible evidence to the contrary).

Some courts have addressed the extent to which objective good faith imposes a duty of inquiry upon a holder. In ***Agriliance, L.L.C. v. Runnels Grain Elevator, Inc.***, 272 F.Supp. 2d 800 (S.D. Iowa 2003), a grain elevator purchased grain from a farm and made payment by issuing checks payable to various of the farm's landlords. The grain, however, was subject to a security interest of another creditor, and that creditor brought an action for conversion of the grain's proceeds against the landlords. The landlords responded that they had taken the checks as holders in due course and thus free of plaintiff's claim. There was no dispute that the landlords did not have actual knowledge of plaintiff's security interest and therefore acted with subjective good faith. The plaintiff argued, however, that the landlords, upon receiving a check from a grain elevator, should have known that it was given in payment of crops and that farmers regularly pledge their crops as collateral. Reasonable commercial standards of fair dealing thus should have required the landlords to conduct a lien search, thereby revealing plaintiff's security interest. The court disagreed, finding that objective good faith "cannot be conflated with a general duty of care" and "imposes no general duty of inquiry." The court suggested, however, that fair dealings may have required such a search if the landlords were shown to have had constructive notice of plaintiff's claim. *See* ***Agriliance,*** 272 F. Supp. at 811-14.

In another case, the court found that whether or not objective good faith imposed a duty of inquiry upon the holder presented a question for the jury. *See* ***Gerber & Gerber, P.C. v. Region Bank***, 52 UCC Rep. Serv. 2d 815 (Ga. App. 2004). The defendant - bank had accepted checks payable to the plaintiff, a law firm with an account at the bank. The law firm's employee, however, fraudulently indorsed those checks in blank and deposited them in her bank account. When the law firm brought suit to recover upon those checks, the bank moved for summary judgment on the ground, among other, that it took them as a holder in due course. The trial court, in a decision affirmed on appeal, denied that motion. Since the bank was aware that the law firm normally indorsed for deposit only any checks payable to it, a trial was necessary to determine whether the bank "dealt with [the law firm] unfairly by not making inquiry" when presented with the checks indorsed in blank. *See* ***Gerber & Gerber,*** UCC Rep. Serv. 2d at 821.

There have been two reported cases where the holder was found to have taken checks with subjective but not objective good faith. Both of those cases addressed a holder's fair dealings in providing immediate credit against uncollected funds and underscore the impact that objective good faith can have upon a holder seeking due course status.

In ***Maine Family Fed. Credit Union,*** 727 A.2d 335, a credit union provided immediate credit against several checks negotiated to it by its member. That member, however, had fraudulently procured the earlier negotiation of those checks to bearer. The credit union was therefore unable to fully collect on them once their payment was stopped. It brought suit against the checks' drawers and earlier indorsers, claiming it was a holder in due course entitled to enforce the checks' payment. A jury ultimately found that the credit union acted with subjective but not objective good faith when it allowed immediate credit on checks totaling over $120,000 and drawn on an out-of-state bank without either: (1) further investigation to assure that they would be paid by the drawee-bank or (2) holding them for a reasonable period of time to allow any irregularities to come to light. Both the credit union's internal policy and applicable federal regulations permitted but did not require a hold on uncollected funds under those circumstances. The Maine Supreme Court nonetheless found that the jury rationally concluded that the credit union had acted pursuant to commercial standards in providing immediate credit but that those standards did not result in fair dealings in the case before it. *See* ***Maine Family Fed. Credit Union,*** 927 A.2d at 340-45.

A similar result was reached in ***Any Kind Checks Cashed, Inc. v. Talcott,*** 830 So.2d 160 (Fla. App. 2002), where an elderly man was fraudulently induced to draw a $10,000 check payable to an associate of his financial advisor. The payee then brought the check to plaintiff, a check cashing outlet, and advised it that he was the drawer's broker and that the check had been issued for investment purposes. After unsuccessfully attempting to verify this story with the drawer, the plaintiff cashed the check and the payee pocketed the proceeds. The drawer put a stop on his check but the plaintiff argued it was nonetheless entitled to enforce its payment as a holder in due course. The court found that these facts "presented neither the typical customer, nor the typical transaction of a check cashing outlet", and noted that check cashing outlets in some instances verify a check with the drawer before cashing it. Thus "[i]n this case, reasonable commercial fairness required the plaintiff to approach the $10,000 check with some caution and to verify it with the [drawer] if it wanted to preserve its holder in due course status". A "loose application of the objective component of 'good faith' would make check cashing outlets the

easy refuge of scam artists who want to take the money and run". The court stressed, however, that "[v]erification with the [drawer] of a check will not be necessary in the vast majority of cases arising from check cashing outlets". *See Talcott,* 830 So.2d at 164-68. (emphasis in original)

Conclusion

Notwithstanding that a holder's burden as to its objective good faith is arguably greater as compared to its subjective counterpart, few reported decisions to date have denied due course status solely because of the lack of objective good faith. Some may conclude from those decisions that objective good faith has not had the dramatic effect on the "wheels of commerce" predicted by some. Such a conclusion may be premature. The courts have not yet fully developed a body of law as to what "fair dealings" requires of a holder and it remains to be seen how objective good faith will be construed in numerous situations not yet addressed. This uncertainty may cause the "wheels of commerce", at the very least, to turn a little more slowly.

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1. *See* Negotiable Instruments (With Conforming and Miscellaneous Amendments to Articles 1 and 4), 1990 Official Text and Comments (American Law Institute and National Conference of Commissioners on Uniform State Laws). Revised Article 3, in some instances with variations from the Official Text, has now been adopted by all states except New York and South Carolina.

2. A party becomes a "holder" by taking possession of a negotiable instrument in one of two ways: (1) the instrument when issued to the party is payable to such party's order or to bearer or (2) the instrument was transferred to such party by negotiation. *See* UCC § R1-201(a)(21).

3. A negotiable instrument is a signed writing evidencing an unconditional promise or order to pay a fixed sum of money on demand or at a definite time. *See* UCC §§ R3-103 and 104. The most common types of negotiable instruments are drafts (including checks) and in some instances promissory notes.

4. Those "real defenses" are: (1) infancy (to the extent a defense to a simple contract); (2) duress, lack of legal capacity and illegality (only if of the type that renders an obligation void, rather than merely voidable); (3) fraud in the factum; (4) discharge in insolvency proceedings; and (5) any "discharge" defense of which the holder had knowledge of when it took the instrument. *See* UCC § R3-305(1)(a) and Official Comment 1; UCC § R3-302(b).

5. In addition, the instrument, when issued or negotiated to the holder, cannot have bore such apparent evidence of forgery or alteration, or otherwise been so irregular or incomplete as to call its authenticity into question. *See* UCC §R3-302(a)(1). Notwithstanding its compliance with Revised Article 3's requirements, a holder may not become a holder in due course where it acquires the instrument (1) at a judicial sale or by legal process; or (2) by taking over an estate; or (3) as part of a bulk transaction not in the transferor's ordinary course of business. *See* UCC § R3-302(c).

6. Several states, including Alabama, Idaho, Louisiana, Missouri, Tennessee and Utah, declined to adopt this objective component of good faith when enacting Revised Article 3.

MATTERS OF MAJOR INTEREST

"VERTICAL" PRIVITY WITH MANUFACTURER NOT REQUIRED FOR CONSUMER ACTION FOR ECONOMIC LOSS BASED ON IMPLIED WARRANTY OF MERCHANTABILITY

[See UCC Case Digest 2314.4(1), 2314.6(4), 2314.6(5), 2318.3(6), 2318.5(11), 2714.9].

A consumer may sue a manufacturer for economic loss based on breach of the implied warranty of merchantability even if the consumer purchased the product from an intermediary in the distribution chain, the Supreme Court of **Indiana** recently decided. There is no requirement of "vertical" privity for such a claim, it ruled. Therefore, a woman who bought an automobile from a dealer and who, over time, experienced problems with the vehicle that could not be satisfactorily repaired during a series of attempts could maintain an action against the manufacturer of the car based on an alleged breach of the manufacturer's implied warranty of merchantability, despite her lack of "vertical" privity with the manufacturer.

The court began by noting that an implied warranty of merchantability imposed by operation of law is to be liberally construed in favor of the buyer. It then summarized the principles of privity in consumer and warranty cases and their development over time, including the development of Indiana case law and statutory provisions and comments about the rules in other jurisdictions. The basis for the privity requirement in a contract claim, the court said, is essentially the idea that the parties to a sale of goods are free to bargain for themselves and thus allocation of risk of failure of a product is best left to the private sector; the law should not impose a contract the parties do not wish to make. However, the court felt that this rationale has eroded to the point of invisibility as applied to many types of consumer goods in today's economy. The UCC recognizes an implied warranty of merchantability if "goods" are sold to "consumers." Nowadays warranties are often explicitly promoted as marketing tools, and consumer expectations are framed by these legal developments, to the point where technically advanced consumer goods are virtually always sold under express warranties, which, as a matter of federal law, runs to consumers without requirement of privity. Given this framework, ordinary consumers are entitled to, and do, expect that a