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## The "Negotiable" Non-Negotiable Instrument: A Vagary of Indiana Commercial Law

HAROLD GREENBERG\*

### I. INTRODUCTION

A little known or remembered feature of the Indiana law of commercial paper is the existence, since the early days of statehood, of a form of commercial paper which may be called the "negotiable non-negotiable instrument." This instrument is still viable today as a consequence of the legislature's failure to repeal chapter 75 of the Acts of 1861 (1861 Act)<sup>1</sup> when it enacted the Uniform Negotiable Instruments Law (NIL) in 1913<sup>2</sup> and the Uniform Commercial Code (UCC) fifty years later in 1963.<sup>3</sup>

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\*Associate Professor of Law, Indiana University School of Law—Indianapolis. A.B., Temple University, 1959; J.D., University of Pennsylvania, 1962.

<sup>1</sup>Act of Mar. 11, 1861, ch. 75, 1861 Ind. Acts 145 (currently codified at IND. CODE §§ 26-2-3-1 to -14 (1982)). Following its enactment in 1861, the Act was codified at various locations in the subsequent editions of the Indiana Code: §§ 5501 to 5518 (1881); §§ 7515 to 7532 (Burns 1894); §§ 9071 to 9089 (Burns 1908); §§ 11342 to 11359 (Burns 1926); §§ 19-1901 to 19-1918 (Burns 1950). The full title of the Act is:

An Act concerning promissory notes, bills of exchange, bonds, or other instruments in writing, signed by any person who promises to pay money or acknowledges money to be due, or for the delivery of any specific article, or to convey property, or to perform any stipulation therein mentioned, and repealing all laws coming in conflict therewith.

Citations in this article to the 1861 Act will be to the Act's current codification in the 1982 Indiana Code.

<sup>2</sup>Uniform Negotiable Instruments Law, ch. 63, 1913 Ind. Acts 120 [hereinafter referred to as the NIL]. The Uniform Commercial Code (UCC) expressly repealed the NIL, see IND. CODE § 26-1-10-102(1) (1982); however, prior to being superseded by the UCC, the NIL had been adopted in every state. See UNIF. NEGOTIABLE INSTRUMENTS ACT Table III, 5 U.L.A. x (1943).

<sup>3</sup>Uniform Commercial Code, ch. 317, 1963 Ind. Acts 539 (current version codified at IND. CODE §§ 26-1-1-101 to 26-1-10-106 (1982)). All references to the UCC and its official comments shall be to the official UCC section numbers, i.e., U.C.C. §§ 1-101 to 10-106 (West 1978), not to the Indiana Code section numbers. The official comments to the UCC can also be found in West's Annotated Indiana Code following the appropriate sections of the UCC as adopted in Indiana.

This Article compares the significant characteristics of such instruments with those of negotiable and other instruments governed by Article 3 of the UCC. The principal focus will be upon claims of title, defenses and set-offs, and the liability of indorsers and accommodation parties. Because of some noteworthy differences between the 1861 Act and the UCC in some of these areas, the 1861 Act may provide a useful tool for practitioners who are aware of its provisions. At the same time, it may create a trap for those who are not. The author concludes that the 1861 Act should be completely revised so as to make transfer of non-negotiables consistent with UCC-controlled transfers.

## II. BACKGROUND

### A. *The Existence of Negotiable Non-Negotiable Instruments*

When Indiana adopted the UCC, Article 3 of which replaced the NIL,<sup>4</sup> one of the expressly declared purposes was "to simplify, clarify and modernize the law governing commercial transactions."<sup>5</sup> Despite this declaration, the legislature repealed the 1861 Act only insofar as it was inconsistent with the UCC.<sup>6</sup> That the 1861 Act and the UCC can co-exist is clear from both the UCC itself, which declares that the general principles of law and of the law merchant supplement the UCC's provisions,<sup>7</sup> and the official comments, which acknowledge the existence of statutes such as the 1861 Act as well as the commercial paper created thereby.<sup>8</sup> In addition to declaring certain promissory notes to be fully negotiable under the law merchant, the 1861 Act imparted to practically all written promises not negotiable under the law merchant some of the characteristics attributed to negotiability.<sup>9</sup> This created a class of instruments which may be described as "negotiable non-negotiable instruments."

### B. *Negotiable Instruments, the Law Merchant, and Related Concepts*

It is important at this point to clarify the meaning of the terms to be used in this Article. The UCC uses "negotiable" and "instrument"

<sup>4</sup>See U.C.C. § 10-102(1); *id.* § 3-101 official comment (stating that Article 3 "represents a complete revision and modernization of the Uniform Negotiable Instruments Law").

<sup>5</sup>*Id.* § 1-102(2)(a).

<sup>6</sup>*Id.* § 10-102(3).

<sup>7</sup>*Id.* § 1-103.

<sup>8</sup>*Id.* § 3-104 official comment. One commentator observed that in view of the uniformity sought by the NIL and its strict requirements for negotiability, the 1861 Act must have been repealed by implication. See Culp, *Negotiability of Promissory Notes Payable in Specifics*, 9 Miss. L.J. 277, 278-80 (1937). The Indiana cases, however, prove the contrary and show that the 1861 Act coexisted with the NIL and gave some characteristics of negotiability to promissory notes not meeting the NIL's requirements for negotiability. See Guio v. Lutes, 97 Ind. App. 157, 184 N.E. 416 (1933); Smith v. Zabel, 86 Ind. App. 310, 157 N.E. 551 (1927).

<sup>9</sup>IND. CODE §§ 26-2-3-1, -6 (1982).

interdependently so that "instrument" is defined as "a negotiable instrument."<sup>10</sup> A "negotiable instrument" is itself strictly limited to drafts, checks, notes, and certificates of deposit which comply with the specific requirements of UCC section 3-104 and the sections immediately following.<sup>11</sup>

UCC section 3-805 also refers to an "otherwise negotiable" instrument as a draft, check, note, or certificate of deposit which complies with all of the requirements of UCC section 3-104 except that it lacks the words of negotiability, "payable to order or to bearer."<sup>12</sup> The UCC's official comments speak of this instrument as "*the* non-negotiable instrument,"<sup>13</sup> as if it were the only paper to be so designated, and state further that such a "'non-negotiable instrument' is treated as a negotiable instrument, so far as form permits,"<sup>14</sup> but there can be no holder in due course of such an instrument.<sup>15</sup>

Falling somewhere between the UCC's negotiable instrument and its "otherwise negotiable" instrument is the negotiable instrument which is overdue when it comes into the hands of a new holder. Although such an instrument satisfies *all* of the UCC's requirements for negotiability, the fact that it is overdue when negotiated, a fact which appears on its face, precludes the new holder from being a holder in due course.<sup>16</sup>

Any other paper which for any reason fails to satisfy section 3-104 or 3-805 is not a "non-negotiable instrument" for UCC purposes,<sup>17</sup> and "is entirely outside the scope of [Article 3] and [is] to be treated as a

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<sup>10</sup>U.C.C. § 3-102(1)(e).

<sup>11</sup>*Id.* § 3-104(1). This subsection states that for a writing to be a negotiable instrument within Article 3 it

must (a) be signed by the maker or drawer; and (b) contain an unconditional promise or order to pay a sum certain in money and no other promise . . . except as authorized by [Article 3]; and (c) be payable on demand or at a definite time; and (d) be payable to order or to bearer.

Sections 3-105 to 3-119 further refine or explain the general requirements of § 3-104.

<sup>12</sup>*Id.* § 3-805.

<sup>13</sup>*Id.* § 3-805 official comment (emphasis added).

<sup>14</sup>*Id.*

<sup>15</sup>*Id.* § 3-805 & official comment. Professor Beutel lamented that this section, then numbered 3-705, "creates a new technical term, 'non-negotiable instrument' which now becomes subject to all the rules of the Article [3] except that nobody can be a holder in due course." He continued that "no practical advantage seems to have been gained by creating this uncommon type of 'non-negotiable instrument.'" Beutel, *Comparison of the Proposed Commercial Code, Article 3, and the Negotiable Instruments Law*, 30 NEB. L. REV. 531, 556-57 (1951). See generally Note, *Liabilities of the Transferor of Non-Negotiable Instruments under the Proposed Commercial Code*, 98 U. PA. L. REV. 213 (1949).

<sup>16</sup>See U.C.C. § 3-302. It should be noted that the transferee of an overdue negotiable instrument may have the rights of a holder in due course pursuant to the UCC's shelter rule, *id.* § 3-201, if his transferor was a holder in due course. The shelter rule cannot protect the holder of an otherwise negotiable instrument whose transferor could not have been a holder in due course.

<sup>17</sup>See *id.* § 3-104 official comment 1.

simple contract."<sup>18</sup> Subsection 3-104(3) does state that "the terms 'draft,' 'check,' 'certificate of deposit' and 'note' may refer to instruments which are not negotiable within this Article as well as to instruments which are so negotiable,"<sup>19</sup> but the official comment to this subsection refers directly to section 3-805, thereby indicating that the "instruments" which are not negotiable in UCC parlance are the "otherwise negotiable" instruments of section 3-805.<sup>20</sup> The official comments do concede, however, that there are state statutes older than the UCC which make other promises "negotiable" and that such statutes may continue to apply to paper not controlled by the UCC.<sup>21</sup> The 1861 Act is such a statute.

The UCC's requirements for negotiability are essentially the same as those extant under the law merchant of the last century,<sup>22</sup> the UCC being a "complete revision and modernization of the Uniform Negotiable Instruments Law,"<sup>23</sup> itself a codification of the law merchant.<sup>24</sup>

<sup>18</sup>*Id.* § 3-805 official comment.

<sup>19</sup>*Id.* § 3-104(3).

<sup>20</sup>*See id.* § 3-104 official comment 6 ("Subsection (3) is intended to make clear the same policy expressed in Section 3-805.").

<sup>21</sup>*Id.* § 3-104 official comment 1.

<sup>22</sup>For a promissory note to be negotiable at common law pursuant to the law merchant, certainty was required as to (1) the persons entitled to be paid the money (order or bearer), (2) the payors and the conditions of their liability, (3) the amount, (4) the time of payment, and (5) the fact of payment. 1 T. PARSONS, A TREATISE ON THE LAW OF PROMISSORY NOTES AND BILLS OF EXCHANGE 30 (1873). *See, e.g.*, *Glidden v. Henry*, 104 Ind. 278, 279-80, 1 N.E. 369, 370-71 (1885) (quoting PARSONS); *Walker v. Woollen*, 54 Ind. 164, 166 (1876) ("A note, in order that it be negotiable in accordance with the law merchant, must be payable unconditionally and at all events, and at some fixed period of time, or upon some event which must inevitably happen."); *Nicely v. Commercial Bank*, 15 Ind. App. 563, 565, 44 N.E. 572, 573 (1896) (A negotiable promissory note must have on its face "(1) a date; (2) an unconditional promise to pay money; (3) a fixed time for payment; (4) a definite amount to be paid; (5) a place where payment is to be made."). *Accord Nicely v. Winnebago Nat'l Bank*, 18 Ind. App. 30, 41, 47 N.E. 476, 479 (1897) (repeating, without citation, the classic phrase from *Overton v. Tyler*, 3 Pa. 346, 347 (1846), that a negotiable instrument must be a "'courier without luggage'"). Compare the language of UCC 3-104(1), *supra* note 11, which is substantially similar to the law merchant's requirements for negotiability.

<sup>23</sup>U.C.C. § 3-101 official comment.

<sup>24</sup>*Paxton v. Miller*, 102 Ind. App. 511, 513-14, 200 N.E. 87, 88 (1936); Beutel, *Problems of Interpretation Under the Negotiable Instruments Law*, 27 NEB. L. REV. 485, 503 (1948); Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1069-70 (1954) [hereinafter cited as *Good Faith Purchase*]; Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 613 (1981) [hereinafter cited as *Confessions*]. It is highly unlikely that an instrument which would have been negotiable under the law merchant will not today meet the UCC's requirements for negotiability. The converse is not necessarily true, and it is possible for a note negotiable under the UCC to fail to have satisfied the requirements for negotiability under the law merchant. *See, e.g.*, *South Whitley Hoop Co. v. Union Nat'l Bank*, 53 Ind. App. 446, 101 N.E. 824 (1913) and cases cited therein, holding that a provision for payment "with exchange" rendered uncertain the respective amounts payable and destroyed the negotiability of the instruments involved. Under the UCC, identical language has no effect on negotiability. *See* U.C.C. § 3-106(1)(d). Similarly, although a note containing

The 1861 Act uses "instrument" in its very broadest sense to mean practically any written undertaking, whether in the form of a note, draft, acknowledgement of debt, or promise to perform an act.<sup>25</sup> Furthermore, the 1861 Act uses "negotiable" far more broadly than either the UCC or the law merchant so that all such "instruments" are "negotiable by endorsement thereon, so as to vest the property thereof in each endorsee successively."<sup>26</sup>

Unless the context otherwise requires, this Article will use "instrument" to mean any promissory note, draft, check, certificate of deposit, or other obligation to pay money, whether or not it is negotiable under the UCC or the law merchant. A "non-negotiable instrument" will mean one which is not negotiable under the UCC or the law merchant. A "negotiable instrument" is one which is fully negotiable under the law merchant, and therefore also negotiable under the UCC. An "otherwise negotiable" instrument is one which satisfies all of the UCC's requirements for negotiability except for the absence of the words of negotiability, "payable to order or to bearer."<sup>27</sup> An "overdue negotiable instrument" is an instrument which satisfies the UCC's requirements for negotiability but is already overdue when acquired by the current holder.

### C. The Provisions of the 1861 Act

The 1861 Act has been characterized as "the Indiana version of the Statute of Anne."<sup>28</sup> The reasoning given for the adoption of the Act and its predecessors<sup>29</sup> was that until the enactment of the Statute of Anne in 1704,<sup>30</sup> bills of exchange (today more commonly called drafts)<sup>31</sup> were

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a provision which permits the holder to extend the time for payment was not negotiable as a bill of exchange under the law merchant, *see, e.g.*, *Glidden v. Henry*, 104 Ind. 278, 281, 1 N.E. 369, 371 (1885), such a note is negotiable under the UCC. *See* U.C.C. § 1-309(1)(d).

<sup>25</sup>IND. CODE § 26-2-3-1 (1982). *See infra* note 36. *See, e.g.*, *Magic Packing Co. v. Stone-Ordean Wells Co.*, 158 Ind. 538, 64 N.E. 11 (1902) (contract to sell cases of canned apples); *Johnson School Township v. Citizens Bank*, 81 Ind. 515 (1882) (document which stated "there is due . . . and payable a sum for school furniture" but contained no express words of promise); *Craig v. Encey*, 78 Ind. 141 (1881) (appeal bond); *Drake v. Markle*, 21 Ind. 433 (1863) (certificate of deposit); *Mewherter v. Price*, 11 Ind. 199 (1858) (contract to deliver hogs). *But cf.* *McCurdy v. Bowes*, 88 Ind. 583 (1883) (completely ignoring the 1861 Act and failing to apply it to an insolvent corporation's certificate of indebtedness which acknowledged money to be due).

<sup>26</sup>IND. CODE § 26-2-3-1 (1982).

<sup>27</sup>U.C.C. § 3-805.

<sup>28</sup>H. PRATTER & R. TOWNSEND, INDIANA UNIFORM COMMERCIAL CODE WITH COMMENTS § 3-805 comments (1963) [hereinafter cited as PRATTER & TOWNSEND]. *See Bullitt v. Scribner*, 1 Blackf. 14, 14-15 (Ind. 1818).

<sup>29</sup>*See, e.g.*, Act of Jan. 29, 1818, ch. 37, 1818 Ind. Acts 232 (substantially similar to the 1861 Act); *Reid v. Ross*, 15 Ind. 265 (1860).

<sup>30</sup>3 & 4 ANNE, ch. 9, § 1 (1704) (entitled "An act for giving like remedy upon promissory notes, as is now used upon bills of exchange, and for the better payment of inland bills of exchange.').

<sup>31</sup>*See* U.C.C. § 3-104(2)(a).

negotiable at common law, which included the law merchant, but promissory notes were not negotiable.<sup>32</sup> Further, since Indiana's adoption of the common law of England related back to 1607 and incorporated nothing of English law after that date, the Statute of Anne never became the law of Indiana.<sup>33</sup> Thus, according to such reasoning, promissory notes in Indiana could be made negotiable only pursuant to an act of the legislature.<sup>34</sup>

Unlike the Statute of Anne, which dealt only with promissory notes,<sup>35</sup> the 1861 Act declared four distinct categories of written instruments to be negotiable: (1) obligations to pay money, whether promised or acknowledged to be due; (2) promises to deliver specific articles; (3) promises "to convey property"; and (4) promises "to perform any stipulation" contained in the writing.<sup>36</sup> The form could be that of a promissory note, bill of exchange, bond, or "other instrument in writing."<sup>37</sup>

<sup>32</sup>Holloway v. Porter, 46 Ind. 62, 64-66 (1874); Mix v. State Bank, 13 Ind. 521, 521-23 (1859); Bullitt v. Scribner, 1 Blackf. 14, 14-15 (Ind. 1818).

<sup>33</sup>Holloway v. Porter, 46 Ind. 62, 64-66 (1874); Mix v. State Bank, 13 Ind. 521, 521-23 (1859); Bullitt v. Scribner, 1 Blackf. 14, 14-15 (Ind. 1818).

<sup>34</sup>Holloway v. Porter, 46 Ind. 62, 64-66 (1874); Mix v. State Bank, 13 Ind. 521, 521-23 (1859); Bullitt v. Scribner, 1 Blackf. 14, 14-15 (Ind. 1818). Cf. J. BYLES, A TREATISE OF THE LAW OF BILLS OF EXCHANGE, PROMISSORY NOTES, BANK-NOTES AND CHECKS 15 (6th Am. ed. 1874); J. CHITTY & J. HULME, A PRACTICAL TREATISE ON BILLS OF EXCHANGE, CHECKS ON BANKERS, PROMISSORY NOTES, BANKERS' CASH NOTES, AND BANK NOTES 517-18 (10th Am. ed. 1842); 2 T. STREET, THE FOUNDATIONS OF LEGAL LIABILITY 383-86 (1906). The proposition that promissory notes were not negotiable until enactment of the Statute of Anne, as stated in the foregoing cases, has been under attack for many years and is probably incorrect. See 5 U.S. (1 Cranch) app. note (A) 367-75 (1804); C. NORTON, HANDBOOK ON THE LAW OF BILLS AND NOTES 7-8 (4th ed. 1914); J. STORY, COMMENTARIES ON THE LAW OF PROMISSORY NOTES § 6 (1845); Aigler, *Commercial Instruments, The Law Merchant, and Negotiability*, 8 MINN. L. REV. 361, 366-68 (1924); Reed, *The Origin, Early History, and Later Development of Bills of Exchange and Certain Other Negotiable Instruments*, 4 CAN. B. REV. 665, 678 (1926); Notes and Comment, *Bills and Notes: Non-negotiable Notes: Presumption of Consideration*, 9 CORNELL L.Q. 182, 184 (1924). The more accurate position is that promissory notes were negotiable under both the law merchant and the common law and that the Statute of Anne was a Parliamentary declaration of the common law in direct response to several then recent decisions of Lord Holt to the contrary. Cf. Holdsworth, *The Origins and Early History of Negotiable Instruments. IV*, 32 LAW Q. REV. 20, 32-36 (1916), in which the author is somewhat more sympathetic to Lord Holt's position on the matter.

<sup>35</sup> & 4 ANNE, ch. 9 (1704).

<sup>36</sup>IND. CODE § 26-2-3-1 (1982). The precise language is:

All promissory notes, bills of exchange, bonds or other instruments in writing, signed by any person who promises to pay money, or acknowledges money to be due, or for the delivery of a specific article, or to convey property, or to perform any stipulation therein mentioned, shall be negotiable by endorsement thereon, so as to vest the property thereof in each endorsee successively.

<sup>37</sup>*Id.* It has been suggested that statutes declaring written promises other than those to pay money to be negotiable were enacted by states "perhaps because of a primitive financial

In a manner similar to the Statute of Anne, the 1861 Act made promissory notes negotiable, as were bills of exchange under the law merchant, but expressly limited such negotiability to promissory notes payable to order or bearer *in an Indiana bank*,<sup>38</sup> a limitation which had no counterpart in the Statute of Anne.<sup>39</sup> Consequently, to be negotiable under the law merchant in Indiana, a promissory note was required to be payable in an Indiana bank *and* to possess all of the strict requirements for negotiability imposed by the law merchant.<sup>40</sup> Any other note was negotiable only within the terms of the Act.

The 1861 Act provided further that the assignee may bring suit in his own name against the maker,<sup>41</sup> but the maker may assert against the assignee any "defense or set-off" which the maker may have had against any prior assignee or the payee before notice of the assignment.<sup>42</sup> The assignee could also pursue any indorser, but only after using "due diligence" to collect from the maker.<sup>43</sup> In such a suit against a prior indorser, the prior indorser could raise any defense he might have had against his immediate assignee.<sup>44</sup> Promissory notes payable at an Indiana bank were made negotiable as bills of exchange<sup>45</sup> and were not governed by these statutory provisions because the 1861 Act expressly stated that it did not modify the law applicable to bills of exchange, namely, the law merchant.<sup>46</sup>

Since the UCC, by its terms, applies to the negotiable instrument or otherwise negotiable instrument as defined in Article 3,<sup>47</sup> and as previously defined by the law merchant,<sup>48</sup> it is clear that the portion of the 1861

system or for other reasons connected with their local economy." Culp, *supra* note 8, at 277. Accord U.C.C. § 3-104 official comment 1.

<sup>38</sup>IND. CODE § 26-2-3-6 (1982) ("Notes payable to order or bearer in a bank in this state shall be negotiable as inland bills of exchange, and the payees and endorsees thereof may recover as in the case of such bills.").

<sup>39</sup>See *Mix v. State Bank*, 13 Ind. 521 (1859).

<sup>40</sup>See IND. CODE § 26-2-3-6 (1982). See *supra* note 38 and accompanying text.

<sup>41</sup>IND. CODE § 26-2-3-2 (1982).

<sup>42</sup>*Id.* § 26-2-3-3 ("Whatever defense or setoff the maker of any such instrument had, before notice of assignment, against an assignor, or against the original payee, he shall have also against their assignees").

<sup>43</sup>*Id.* § 26-2-3-4. For a discussion of due diligence, see *infra* notes 152-69 and accompanying text.

<sup>44</sup>The language of Indiana Code section 26-2-3-4 creates an ambiguity by the use of the words "he shall have any defense" with no clear indication as to which party the "he" refers. Initially, it would appear that "he shall" should be read as parallel to "[a]ny such assignee . . . shall." IND. CODE § 26-2-3-4 (1982). However, the only party who logically would be asserting a defense against his immediate assignee is the remote indorser-defendant, not the current assignee-plaintiff.

<sup>45</sup>*Id.* § 26-2-3-6.

<sup>46</sup>*Id.* § 26-2-3-5.

<sup>47</sup>See *supra* notes 10-18 and accompanying text.

<sup>48</sup>See *supra* notes 22-24 and accompanying text.

Act which made promissory notes payable at an Indiana bank negotiable pursuant to the law merchant<sup>49</sup> has been repealed. However, the non-negotiable instrument, as here defined, is entirely outside the scope of the UCC and therefore remains subject to the 1861 Act.

At this point, one should note that the major distinctions between non-negotiable paper, absent any applicable statute such as the 1861 Act, and paper negotiable under the law merchant, the NIL, and UCC have been characterized as (1) the requirement that a transferee of non-negotiable paper, even if he takes in good faith, for value, and without notice of claims or defenses, must notify the obligor of the transfer in order to cut off defenses subsequently acquired by the obligor, such notification not being required of a holder in due course of negotiable paper; (2) the power of the holder of negotiable paper to transfer free of equities and defenses, a power not possessed by the transferor of non-negotiable paper; and (3) the presumption of consideration in the case of negotiables, which does not exist in the case of non-negotiables.<sup>50</sup> The 1861 Act and the cases decided under it have blurred or eliminated some of these distinctions.

### III. SIGNIFICANT FEATURES OF NEGOTIABLE AND "NEGOTIABLE" NON-NEGOTIABLE INSTRUMENTS

Three of the major issues relating to any instrument are (1) the effect of the vesting of property in the instrument as a consequence of indorsement, (2) the nature and extent of the defenses or set-offs available to the maker or drawer or to a remote indorser in an action by the current holder, and (3) the nature and extent of the liability of indorsers in the chain of title.

#### A. *The Effect of Indorsement on Title and Claims to the Instrument*

The holder in due course of a negotiable instrument has been characterized as a "superplaintiff,"<sup>51</sup> an appropriate characterization because he takes free of *all* claims and most defenses under both the UCC<sup>52</sup> and the law merchant.<sup>53</sup> The UCC's other holder, the holder not in due course, is not as fortunate because he takes subject to all claims and

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<sup>49</sup>IND. CODE § 26-2-3-6 (1982).

<sup>50</sup>See Goodrich, *Non-Negotiable Bills and Notes*, 5 IOWA L. BULL. 65, 67 (1920).

<sup>51</sup>J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 14-1 (2d ed. 1980) [hereinafter cited as WHITE & SUMMERS].

<sup>52</sup>See U.C.C. § 3-305.

<sup>53</sup>See, e.g., *Eichelberger v. Old Nat'l Bank*, 103 Ind. 401, 3 N.E. 127 (1885); *Ruddell v. Fhalor*, 72 Ind. 533 (1880); *Bremmerman v. Jennings*, 60 Ind. 175 (1877); *Hereth v. Merchants' Nat'l Bank*, 34 Ind. 380 (1870).



defenses.<sup>54</sup> The texts of both the UCC and the 1861 Act distinguish between and treat separately the defenses of a party to the instrument and the claims of ownership rights in the instrument.<sup>55</sup> As a result of this separate treatment, the ownership rights of holders of non-negotiable instruments are superior to those of holders of overdue or otherwise negotiable instruments and much closer to those of holders in due course under the UCC.

Although the 1861 Act clearly distinguishes between title to instruments and defenses on instruments, the cases under the Act have not always done so, and even those cases which have attempted to draw the distinction have done so in language which only serves to blur rather than to clarify. There are also cases which have totally ignored the existence of the 1861 Act and have treated the instrument involved as if it were a mere contract right rather than an instrument within the 1861 Act.<sup>56</sup> The result is confusion which is both unnecessary and contrary to the purposes of the Act. Although the cases agree that an indorsement is a writing on the back of the note or draft,<sup>57</sup> they do not consistently agree on the effect of an indorsement on the title of the indorsee.

1. *The Distinction Between Claims and Defenses Clarified.*—The leading case on this issue, and the first to properly interpret and apply the 1861 Act, is *Moore v. Moore*,<sup>58</sup> in which a prior indorser of certain non-negotiable promissory notes intervened in the holder's action against the makers. The prior indorser claimed ownership of the notes because her indorsement had been procured by the fraud of her indorsee who, long after the notes were overdue, indorsed to the current holder, an innocent purchaser for value without notice of the fraud. The prior indorser's argument, based on the New York case of *Bush v. Lathrop*,<sup>59</sup> was that an indorsee of non-negotiable notes takes no better interest or title than that of his immediate indorser. Therefore, since the holder-plaintiff's

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<sup>54</sup>U.C.C. § 3-306.

<sup>55</sup>The UCC distinction is made in the sections dealing with the rights of holders. *Id.* § 3-305, 306. See generally WHITE & SUMMERS, *supra* note 51, at § 14-9. The 1861 Act addresses claims and defenses in separate sections. IND. CODE §§ 26-2-3-1, -3 (1982). See *supra* notes 36 and 42.

<sup>56</sup>See, e.g., *McCurdy v. Bowes*, 88 Ind. 583 (1883) (corporate certificate of indebtedness acknowledging debt to be due which the court should have found to be within section 1 of the 1861 Act). Cf. Beutel, *The Development of State Statutes on Negotiable Paper Prior to the Negotiable Instruments Law*, 40 COLUM. L. REV. 836, 864-65 (1940) (in which the author laments "the courts' habit of following or ignoring statutes without citing them").

<sup>57</sup>See, e.g., *Marion & Monroe Gravel Road Co. v. Kessinger*, 66 Ind. 549, 553 (1879) (stating that "the word 'endorsement,' as applied to a note, necessarily implies a writing on the back of the note"); *Reed v. Garr*, 59 Ind. 299, 300 (1877); *Keller v. Williams*, 49 Ind. 504, 505 (1875); *Kern v. Hazlerigg*, 11 Ind. 443, 444 (1858).

<sup>58</sup>112 Ind. 149, 13 N.E. 673 (1887).

<sup>59</sup>22 N.Y. 535 (1860).

immediate indorser acquired no interest in the notes because of his fraud, the prior indorser claimed that she was entitled to possession and ownership of the notes.

After noting that the rule in *Bush* had been repudiated by subsequent New York decisions,<sup>60</sup> the *Moore* court stated that under the 1861 Act, full legal title to a non-negotiable instrument vests in the indorsee and only equitable rights remain in the indorser.<sup>61</sup> The court repeated the maxim that "[i]f one of two equally innocent parties must suffer, the one who, by his indorsement of the instrument, has conferred upon another the apparently absolute ownership of the paper must bear the loss."<sup>62</sup> The court then observed:

The more modern rule upon the subject under consideration seems to be, that where the owner of things in action, although not technically negotiable, has clothed another, to whom they are delivered in the method common to all mercantile communities, with the usual apparent *indicia* of title, he will be estopped from setting up against a second assignee, to whom the securities have been transferred for value and without notice, that the title of the first assignee was not perfect and absolute.<sup>63</sup>

The court specifically distinguished between claims of ownership and defenses to payment, noting that estoppel of a prior assignor's claim would not affect the defenses available to the maker.<sup>64</sup>

2. *The Distinction Between Claims and Defenses Blurred.*—Other cases, both before and after *Moore*, as well as language in *Moore* itself, seem to conflict with the principle enunciated in that case and continued in its progeny.<sup>65</sup> In *Kastner v. Pibilinski*,<sup>66</sup> decided three years before

<sup>60</sup>112 Ind. at 151, 13 N.E. at 675 (citing among others *Moore v. Metropolitan Nat'l Bank*, 55 N.Y. 41 (1873)). *Moore v. Metropolitan National Bank* involved a New York State certificate of indebtedness and overruled *Bush*. Because the analysis which follows in both text and footnotes refers to both *Moore v. Moore* and *Moore v. Metropolitan Nat'l Bank*, the former will be referred to simply as *Moore*, and the latter will be referred to as *Metropolitan*.

<sup>61</sup>112 Ind. at 151, 13 N.E. at 675.

<sup>62</sup>*Id.*

<sup>63</sup>*Id.* at 152-53, 13 N.E. at 676 (citations omitted).

<sup>64</sup>*Id.* at 153, 13 N.E. at 676. The Indiana Supreme Court reaffirmed *Moore* in *Shirk v. North*, 138 Ind. 210, 37 N.E. 590 (1894). In *Shirk*, the payee of non-negotiable notes made a "pretended assignment" by indorsing the notes in blank and delivering them to a party who was selling land to the payee's husband. The seller, who was to hold the notes only as security for the husband's debt, later indorsed the notes to a bona fide purchaser for value. In a single action, the payee sued the holder of the notes for their recovery and the maker for the amount due. The supreme court directed the trial court to sustain the defendants' demurrers. *Id.* at 219, 37 N.E. at 592. See also *Kiefer v. Klinsick*, 144 Ind. 46, 42 N.E. 447 (1895).

<sup>65</sup>See *Shirk v. North*, 138 Ind. 210, 37 N.E. 590 (1894); *Kiefer v. Klinsick*, 144 Ind. 46, 42 N.E. 447 (1895).

<sup>66</sup>96 Ind. 229 (1884).

*Moore*, the holder, a good faith purchaser for value, brought suit against the makers of a past due, non-negotiable note. The payee's daughter claimed ownership of the note, alleging that the payee, who could not read, had been defrauded into believing that he had indorsed to her when in fact he had indorsed to her husband. The husband subsequently indorsed to the holder-plaintiff. The court upheld the daughter's claim, finding that the husband took no title because of his fraud, and could therefore pass no title.<sup>67</sup> The court went on to state that:

The doctrine, that negligence on the part of a maker or endorser of a commercial bill or note will preclude him from defending against an action by a *bona fide* holder, does not obtain in a case where the note assigned is not commercial and is assigned after maturity. Where a commercial note is signed or endorsed, it is marketable in the hands of the holder, and is protected against defences, and men have a right to buy it as an article of commerce, which, by the law, is free from infirmities, but this is not true of a note not commercial and assigned after maturity. Instruments, such as that last named, are not protected in the hands of *bona fide* holders, and one who buys must ascertain whether the person of whom he buys has title, as well as whether the note is subject to defences.<sup>68</sup>

In declaring the applicable rule to be that the purchaser of past due non-negotiable "paper must inquire as to the title of his assignor, and as to defences against the note in the assignor's hands,"<sup>69</sup> the court ignored the 1861 Act and failed properly to distinguish between claims and defenses. The rule that the negligence of the maker or indorser will preclude him from *defending* against a holder in due course was properly found inapplicable to a non-negotiable note assigned after maturity. However, the court also noted that the contest was between the holder and the daughter on her cross-claim, not between the holder and the indorser, thereby confusing claims with defenses.<sup>70</sup>

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<sup>67</sup>*Id.* at 231-32. The court cites *Bush* for support. *Id.* at 233.

<sup>68</sup>*Id.* at 233.

<sup>69</sup>*Id.*

<sup>70</sup>*Id.* at 230, 232. *Robeson v. Roberts*, 20 Ind. 155 (1863), which was relied on in *Kastner* despite its inapplicability on the facts because it involved judgment notes, explained the reason for a distinction between claims and defenses:

The difference between the two cases is clear and substantial. The party proposing to take an assignment of a judgment can go to the judgment debtor and ascertain the true state of the case. If the debtor have [sic] any equitable ground for refusing to pay, he can so state; if not, and he so state [sic] to the party proposing to take an assignment, and the purchase is made on the faith of such disclaimer, he will be thereafter estopped to set up any such matter.

But a party who proposes to purchase a judgment has no means of ascertaining what claims third persons may have, or pretend to have on the judgment, unless such claims appear on or attached to the entry of judgment where the

The court in *Kastner* completely ignored the claim/defense distinction which cuts directly against the result in that case. The language and reasoning in *Kastner* appear to be directly contrary to *Moore*. Nevertheless, the court which in *Moore* had rejected the rule in *Bush*,<sup>71</sup> also stated that its decision was not "opposed" by *Kastner*.<sup>72</sup> Such a finding is confusing indeed. Perhaps the court had in mind a distinction between *Moore* and *Kastner* based on fraud in the factum in *Kastner*, and fraud in the inducement based on lack of consideration in *Moore*, a distinction which continues in the difference between real and personal defenses under UCC section 3-305.<sup>73</sup> If so, the court should have been far more explicit.

*Carithers v. Stuart*,<sup>74</sup> distinguished by *Moore* without explanation,<sup>75</sup> also can be read to conflict with the *Moore* rationale. In *Carithers*, a husband and wife had executed a mortgage as security for a series of the husband's negotiable promissory notes. After a detailed analysis of the facts, the Indiana Supreme Court concluded that because the wife (or her agent) knew or had reason to know that the bank to which the indorsed notes had been delivered possessed authority to collect but not to sell them, she could not acquire title to the notes.<sup>76</sup> Had the *Carithers* decision rested solely on the widow's knowledge of the bank's limited authority, there would be no problem with *Moore's* treatment of the case. However, *Carithers* appears to have relied also on the rule of *Bush*, which, the court acknowledged, had been subsequently "subject to modification"

same is to be assigned. Hence it would seem that an assignee without notice should take the judgment freed from the claims of such third persons.

*Id.* at 161.

*Bush* itself acknowledged that there is a valid distinction between claims and defenses, but the New York court considered itself powerless to change what it perceived to be the then prevailing common law rule that an assignee of a non-negotiable instrument takes subject to all claims as well as to all defenses. 22 N.Y. at 547-59. The court in *Kastner* had also ignored the *Bush* analysis. In *Moore*, the court certainly could have used this analysis to strengthen its decision.

<sup>71</sup>See *supra* notes 59-60 and accompanying text.

<sup>72</sup>112 Ind. at 153, 13 N.E. at 676.

<sup>73</sup>See *WHITE & SUMMERS, supra* note 51, § 14-9; *cf.* *Ruddell v. Dillman*, 73 Ind. 518, 521 (1881) (holding that a man who could not read had negligently failed "to inform himself of the character and contents of the instrument he executed," which was in fact a negotiable promissory note, and was liable to the holder in due course).

<sup>74</sup>87 Ind. 424 (1882).

<sup>75</sup>112 Ind. at 153, 13 N.E. at 676.

<sup>76</sup>87 Ind. at 432-33. The holder of two of the notes had indorsed them to the Indiana bank where they were payable, allegedly for purposes of collection only, but without restrictive language. After one of the notes had been dishonored and was overdue, the bank gave the note to the widow for value. However, the bank did not mark the note paid. The widow, claiming to be the current holder of the notes secured by the mortgage, brought an action to foreclose. The central issue was whether the widow had acquired full ownership rights to the notes as assignee, in which case she would have a creditor's priority in the distribution of the proceeds from the foreclosure sale, or whether she had merely paid off the notes, in which event she would have acquired only limited subrogation rights against other heirs to her husband's estate.

by principles of estoppel in later New York cases.<sup>77</sup> The *Carithers* court concluded that there was no estoppel, in part because the holder never intended to transfer title to the collecting bank.<sup>78</sup> To the extent that this conclusion was based on the payee's intent, as opposed to the widow's notice, it ignored the analysis in the New York cases which discredited *Bush* and which emphasized that the important factor is the appearance that title has been transferred, not the intention of the transferor.<sup>79</sup>

In commenting on *Carithers*, the court in *Moore* considered the case "clearly distinguishable on its facts,"<sup>80</sup> probably because of the previously mentioned knowledge of the widow.<sup>81</sup> However, the court went on to state that *Carithers* "recognizes the doctrine and authorities which control our judgment in this case."<sup>82</sup> To the contrary, *Carithers* did not recognize the appropriate authorities—unless recognition means mere citation of the cases followed by total disregard of the analysis contained in them plus application of the rule discredited by those very cases.

To obfuscate matters further, three years after its rejection of the *Bush* rule in *Moore*, the supreme court expressly reaffirmed the *Bush* rule in *Merrell v. Springer*.<sup>83</sup> In *Merrell*, the court stated that in cases of non-negotiable notes transferred after maturity, "the purchaser must inquire as to the title of his assignor, and as to the defences against the note in the hands of the assignor."<sup>84</sup> The court relied on *Bush* and *Kastner*,<sup>85</sup> both of which have been discussed earlier as being either inconsistent with *Moore* or inapplicable because of important factual differences.<sup>86</sup>

In attempting to distinguish *Moore*, the *Merrell* court ignored the 1861 Act, *Moore's* construction and application of the 1861 Act, and the observation in *Moore* that the *Bush* rule repeatedly had been repudiated in New York and other jurisdictions.<sup>87</sup> The *Merrell* court concentrated instead on the fact that the note in question had never been delivered to the payee from whom the holder had acquired it, whereas in *Moore*, the party claiming ownership rights in the note had himself indorsed and delivered the note "with the intention of vesting in the assignee title" and was estopped from claiming title as against an innocent purchaser.<sup>88</sup>

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<sup>77</sup>*Id.* at 431.

<sup>78</sup>*Id.* at 432.

<sup>79</sup>See *Moore v. Metropolitan Nat'l Bank*, 55 N.Y. 41 (1873); *McNeil v. Tenth Nat'l Bank*, 46 N.Y. 375 (1871).

<sup>80</sup>112 Ind. at 153, 13 N.E. at 676.

<sup>81</sup>See *supra* notes 74-76 and accompanying text.

<sup>82</sup>112 Ind. at 153, 13 N.E. at 676.

<sup>83</sup>123 Ind. 485, 24 N.E. 258 (1890).

<sup>84</sup>123 Ind. at 487, 24 N.E. at 259.

<sup>85</sup>*Id.* at 487-88, 24 N.E. at 259. The court also cites *Robeson v. Roberts*, 20 Ind. 155 (1863), discussed *supra* note 70.

<sup>86</sup>See *supra* notes 66-73 and accompanying text.

<sup>87</sup>123 Ind. at 488-89, 24 N.E. at 259.

<sup>88</sup>*Id.*

The court may have been attempting to establish a rule that in order for a payee to be able to transfer title to a good faith purchaser, the payee himself must have acquired possession by delivery, a result with which *Moore* would be consistent.<sup>89</sup> The reliance on the *Bush* rule and the general requirement that the purchaser check his transferor's title, however, contradict *Moore* and confuse rather than clarify.<sup>90</sup>

3. *Claims of Title Under the UCC and the 1861 Act.*—Close analysis of this entire line of cases, starting with *Moore*, reveals the rather unsettling proposition that the indorsee of a non-negotiable instrument may obtain a better and more secure *title* to that instrument under the 1861 Act than if he were the indorsee of either an otherwise negotiable instrument or an overdue negotiable instrument under the UCC. Under the UCC, a holder in due course of a negotiable instrument takes free from "all claims to it on the part of any person,"<sup>91</sup> while the indorsee of an otherwise negotiable instrument or of an overdue negotiable instrument takes subject to all such claims because he cannot be a holder in due

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<sup>89</sup>Even today, there is ambiguity as to whether delivery is required in order to make the possessor of an instrument a holder under the UCC. See White, *Some Petty Complaints about Article Three*, 65 MICH. L. REV. 1315 (1967). Professor White notes that only a thief will ordinarily become the possessor of an instrument absent delivery to him, and the instrument would necessarily have to be either payable to bearer, indorsed in blank, or payable to the thief as in *Merrell*.

<sup>90</sup>The court's use of language clearly unnecessary to a decision eighteen years after *Moore*, in *Rosenthal v. Rambo*, 165 Ind. 584, 76 N.E. 404 (1905), introduced additional confusion. In that case the buyer of a horse, paid for by giving non-negotiable promissory notes, defended a suit on one of the notes by a bona fide purchaser from the horse-seller, claiming that the horse was worthless and that there was no consideration for the note. These defenses were available to him under section 3 of the 1861 Act, as the court correctly observed. *Id.* at 596, 76 N.E. at 408. In so doing, however, the court used language which was based on section 1 rather than section 3:

The notes in suit belong to this class of instruments [promises assignable under section 1, but citing section 3]. As to them there can be no such thing as a *bona fide* or good faith purchaser, vesting in some assignees a better title than the payee and assignor possessed, as recognized in instruments negotiable by the law merchant. Though promises to pay money, these notes are transferable in the same manner as written promises to deliver particular articles, or to perform particular acts, and appellant, as assignee, took the property in them charged with all the equities, conditions and burdens that adhered to them, precisely as they were held by [the assignor].

*Id.* Moreover, none of the string of cases cited by *Rosenthal* to support this failure to distinguish between defenses and claims of ownership supported its reasoning. Seven of the cases involved non-negotiable notes to which the makers had defenses based on the underlying transactions rather than claims of ownership or title. *Cohen v. Prater*, 56 Ga. 203 (1876); *Henry v. Gilliland*, 103 Ind. 177 (1885); *Herod v. Snyder*, 48 Ind. 480 (1874); *Holman v. Creagmiles*, 14 Ind. 177 (1860); *Second Nat'l Bank v. Wheeler*, 75 Mich. 546, 42 N.W. 963 (1889); *Benton v. Klein*, 42 Mo. 97 (1867); *Wetter v. Kiley*, 95 Pa. 461 (1880). The remaining two cases involved assignments without indorsements. *Smith v. Rogers*, 14 Ind. 224 (1860); *Howell v. Medler*, 41 Mich. 641, 2 N.W. 911 (1879).

<sup>91</sup>U.C.C. § 3-305(1).

course.<sup>92</sup> *Moore* and the cases which follow it stand at least for the principle that pursuant to section 1 of the 1861 Act, if the owner of an instrument is persuaded to transfer ownership to an indorsee, even if by the indorsee's fraud in the inducement, that indorsee may himself transfer good title by indorsing to a bona fide purchaser for value without notice of any infirmity in his seller's title.<sup>93</sup> *Shirk v. North*<sup>94</sup> and *Kiefer v. Klinsick*<sup>95</sup> add that even if the indorsing owner intends to transfer only possession but not ownership, that indorsement, as a consequence of the 1861 Act, effectively clothes the indorsee with a sufficient indicia of ownership so as to empower him to transfer full ownership rights to a bona fide purchaser despite the owner's intentions. Thus, if the reason an instrument lacks negotiability under the UCC is its failure to meet one of the specific requirements of section 3-104,<sup>96</sup> the instrument is completely outside the coverage of the UCC and the indorsee takes free of claims of third persons pursuant to section 1 of the 1861 Act and the cases interpreting it.<sup>97</sup>

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<sup>92</sup>*Id.* § 3-306(a). The fact that an instrument is not negotiable, however, does not necessarily mean that it cannot be transferred free of latent claims of ownership or even free of defenses under certain circumstances, where common law principles such as estoppel or bona fide purchase are applicable. See Beutel, *Negotiability by Contract, A Problem in Statutory Interpretation*, 28 ILL. L. REV. 205, 208-10 (1933) [hereinafter cited as *Negotiability by Contract*]. See *infra* notes 136-43 and accompanying text (discussing estoppel in connection with defenses). Thus, as one scholar observed, a purchase option of an instrument outside the coverage of the NIL or the UCC

is protected against claims of ownership by the so-called indicia of title, estoppel and bona fide purchase, all of which are no part of the law of negotiability; the result being that strictly non-negotiable paper properly worded may pass free of claims of ownership to any bona fide purchaser except one who takes from a thief or a finder.

Beutel, *supra* at 209. The 1861 Act and the line of cases following *Moore* have effectively codified estoppel, indicia of title, and bona fide purchase as part of Indiana's law of negotiable instruments.

<sup>93</sup>This is so despite the court's attempted distinction of *Moore* in *Merrell*.

<sup>94</sup>138 Ind. 210, 37 N.E. 590 (1894). See *supra* note 64.

<sup>95</sup>144 Ind. 46, 42 N.E. 447 (1895).

<sup>96</sup>See, e.g., U.C.C. § 3-105(2) (payable out of a specific fund or governed by the terms of another writing).

<sup>97</sup>In discussing a similar problem under the NIL twenty years ago, one commentator expressed astonishment that "in several situations a holder of a non-negotiable chose in action is afforded greater protection [under the common law] than a holder of a negotiable chose." Olds, *Should Negotiable Instruments Suffer Disadvantages Not Shared by Non-Negotiable Choses in Action*, 2 HOUS. L. REV. 43, 43 (1964). He was particularly concerned with the provisions of the NIL which provided that the taker of an overdue instrument is subject to claims of ownership. *Id.* at 44. Even earlier, Professor Chafee suggested that the bona fide purchaser for value of an overdue negotiable instrument should be able to take free of claims of ownership but should still be subject to defenses of prior parties. Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104, 1108 (1918). The UCC has rejected this suggestion; the indorsee of an overdue negotiable instrument cannot be a holder in due course and therefore takes subject to both claims and defenses. U.C.C. §§ 3-302(1)(c), 3-306.

### B. Defenses and Set-Offs to the Holder's Action

Once the ownership of an instrument is determined, the next issue is what defensive positions are available to a maker in the holder's action on the note to enforce payment. The UCC speaks only of "claims" and "defenses."<sup>98</sup> The 1861 Act speaks of "defense or set-off."<sup>99</sup> Although both defenses and set-offs are raised as defensive responses, cases have drawn a definite distinction between the two:

A set-off, strictly speaking, is not a defence to the action in which it may be filed. It is simply a cross action; and as such it must state facts sufficient to constitute, not a defence to the action in which it may be filed, but a cause of action against the opposite party.<sup>100</sup>

Moreover, set-off was unknown at common law and is based entirely on statute.<sup>101</sup>

1. *Defenses.*—Which holder may be subject to defenses is relatively clear. The UCC states unequivocally that the holder in due course of a negotiable instrument takes free of all defenses except the specifically enumerated real defenses.<sup>102</sup> The UCC also provides that the indorsee who takes an overdue instrument or an otherwise negotiable instrument is not a holder in due course<sup>103</sup> and takes subject to all defenses.<sup>104</sup> The indorsee of the non-negotiable note takes subject to any defenses on the instrument which the maker had against either the payee or subsequent indorsee before the maker received notice of the assignment.<sup>105</sup> Accordingly, the good faith purchaser-indorser for value of a non-negotiable instrument, an overdue negotiable instrument, or an otherwise negotiable instrument stand on the same footing with respect to defenses.

One defense frequently asserted by makers in actions to enforce instruments is lack of consideration. While under the UCC the holder in due course takes free of this defense,<sup>106</sup> and holders of overdue or otherwise negotiable instruments do not,<sup>107</sup> the UCC creates a presumption of

<sup>98</sup>See U.C.C. §§ 3-305, 3-306.

<sup>99</sup>IND. CODE § 26-2-3-3 (1982) (emphasis added).

<sup>100</sup>Kennedy v. Richardson, 70 Ind. 524, 530 (1880). *Accord* McKinney v. Pure Oil Co., 129 Ind. App. 223, 228, 154 N.E.2d 53, 55 (1958). See generally T. WATERMAN, A TREATISE ON THE LAW OF SET-OFF, RECOUPMENT, AND COUNTERCLAIM (2d ed. 1872).

<sup>101</sup>See McKinney v. Pure Oil Co., 129 Ind. App. 233, 228, 153 N.E.2d 53, 55 (1958); O. BARBOUR, A TREATISE ON THE LAW OF SET-OFF (1841); T. WATERMAN, *supra* note 100, at § 10.

<sup>102</sup>U.C.C. § 3-305(2). See also WHITE & SUMMERS, *supra* note 51, at § 14-9.

<sup>103</sup>See *supra* notes 12-16 and accompanying text.

<sup>104</sup>U.C.C. § 3-306(b)-(d). See also WHITE & SUMMERS, *supra* note 51, at § 14-10.

<sup>105</sup>IND. CODE § 26-2-3-3 (1982). Section 3 of the 1861 Act is quoted in full *supra* note 42.

<sup>106</sup>See U.C.C. § 3-305(2).

<sup>107</sup>See *id.* §§ 3-302(1)(c), 3-306(c), 3-805.



consideration in favor of all holders, whether in due course or not. Once a holder introduces the instrument into evidence and establishes the maker's signature, the defendant maker has the burden of establishing whatever defense she may have by a preponderance of the evidence.<sup>108</sup>

The position of the holder of the non-negotiable instrument under the 1861 Act, with respect to the presumption of consideration, is substantially similar to that of a holder under the UCC and is superior to that of the plaintiff in a simple contract action. The cases have stated uniformly that in an action on a note, whether fully negotiable under the law merchant or negotiable only pursuant to section 1 of the 1861 Act, there is a presumption of consideration so that there need be no allegation of consideration in the pleadings and no proof of consideration at trial, unless the defendant introduces evidence of the lack thereof.<sup>109</sup> As the court stated in one case, "The general rule in this State is, that all negotiable paper is presumed to have been given upon sufficient consideration, and this rule obtains, whether the paper sued on be negotiable under the law merchant, or assignable under the provisions of the statute."<sup>110</sup> The plaintiff in a simple contract action, on the other hand, does not enjoy even a presumption of consideration and must allege and prove all elements of recovery, including consideration.

2. *Set-Off*.—The more difficult problem arises with respect to prior party set-off, i.e., whether the maker or drawer of an instrument may assert against a remote indorsee-plaintiff (the holder) a set-off unrelated to the transaction giving rise to the instrument which the maker had against an earlier holder or against the payee.

Although section 3-305 of the UCC says nothing specifically about set-off, it would be totally illogical for the holder in due course, who takes free of all but real defenses, to take subject to a totally unrelated set-off which the maker or drawer may have had against the payee or other prior holder. The only acceptable and logical conclusion is that a set-off which would have been available against a prior party is not available against a holder in due course.<sup>111</sup> This was so under the law

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<sup>108</sup>See *id.* § 3-307(2) & official comment 2; *id.* § 3-408 & official comment 3.

<sup>109</sup>See, e.g., *Louisville, E. & St. L. Ry. Co. v. Caldwell*, 98 Ind. 245, 252 (1884); *Durland v. Pitcairn*, 51 Ind. 426, 438 (1875); *Harden v. Wolf*, 2 Ind. 31, 32 (1850); *Deeter v. Burk*, 59 Ind. App. 449, 460, 107 N.E. 304, 308 (1914); see also *Goodrich*, *supra* note 50, at 71-72 (1920); *Recent Important Decisions, Bills and Notes—Non-Negotiable Notes—Presumption of Consideration*, 24 MICH. L. REV. 63 (1925).

<sup>110</sup>*Durland v. Pitcairn*, 51 Ind. 426, 438 (1875).

<sup>111</sup>See *Britton, Holder in Due Course—A Comparison of the Provisions of the Negotiable Instruments Law with Those of Article 3 of the Proposed Commercial Code*, 49 NW. U.L. REV. 417, 437 (1954) ("If the maker or acceptor has a right of set-off against the payee, obviously, the set-off is unavailable against a holder in due course"); *Morris, The Use of Set-Off, Counterclaim and Recoupment: Availability Against Commercial Paper*, 62 W. VA. L. REV. 140, 155 (1959).

merchant,<sup>112</sup> and there is no reason for a different result under the UCC.

In the case of non-negotiable instruments, the 1861 Act mandates that the indorsee take subject to "[w]hatever defense or setoff" which the maker had against the indorser prior to receiving notice of the assignment by indorsement.<sup>113</sup> Thus, the purchaser for value of a non-negotiable instrument takes subject not only to defenses arising out of the transaction which created the instrument, such as lack of consideration, breach of warranty, or fraud in the inducement,<sup>114</sup> but also to whatever unrelated set-off the maker had against any prior party to the instrument before the maker received notice of transfer by the prior party. There appears to be no disagreement in the cases on this last point,<sup>115</sup> and this comports with the common law of assignments.<sup>116</sup>

Whether the holder of either an overdue or otherwise negotiable instrument under the UCC also takes subject to prior party set-off is substantially less certain. When the UCC was proposed for adoption in Indiana, Professors Pratter and Townsend commented that section 3-306 does not make clear whether the maker's right of set-off based on a cause of action separate from the instrument is cut off by transfer to a subsequent

<sup>112</sup>See *Hankins v. Shoup*, 2 Ind. 342, 343 (1850). "It is decided, *even where a note is overdue when indorsed*, that matter of set-off due from the payee, not arising out of the note transaction, cannot be claimed against the indorsee, though the set-off was due to the maker whilst the payee held the note." *Id.* at 343 (emphasis added).

<sup>113</sup>IND. CODE § 26-2-3-3 (1982) (emphasis added). See *supra* note 42 for text of section 3 of the 1861 Act.

<sup>114</sup>See, e.g., *Rosenthal v. Rambo*, 165 Ind. 584, 76 N.E. 404 (1905) (breach of warranty); *Herod v. Snyder*, 48 Ind. 480 (1874) (breach of warranty); *Holman v. Creagmiles*, 14 Ind. 177 (1860) (failure of consideration); *Doremus v. Bond*, 8 Blackf. 368 (Ind. 1847) (failure of consideration). *But cf.* *Iverson, Enforcement and Negotiation of Government Warrants*, 8 UTAH L. REV. 28, 29 (1962) (listing "set-off" as one of the personal defenses to which the taker of a non-negotiable instrument is ordinarily subject).

<sup>115</sup>The most typical set-off situation has involved the maker's attempt to set off a note or judgment acquired against the payee or a prior indorsee. Where the note or judgment was acquired prior to both the transfer and notice thereof, set-off was proper. See, e.g., *Abshire v. Corey*, 113 Ind. 484, 15 N.E. 685 (1888); *Hoffman v. Zollinger*, 39 Ind. 461 (1872); *King v. Conn*, 25 Ind. 425 (1865); *Woods v. Dalrymple*, 12 Ind. App. 598, 39 N.E. 883 (1895). Where the note being set off was acquired after transfer of the instrument in suit and notice thereof, set-off was improper. See, e.g., *Weader v. First Nat'l Bank*, 126 Ind. 111, 25 N.E. 887 (1890); *Proctor v. Cole*, 115 Ind. 15, 17 N.E. 189 (1888); *Sayres v. Linkhart*, 25 Ind. 145 (1865). See also *Cox v. Bank of Westfield*, 18 Ind. App. 248, 47 N.E. 841 (1897), in which the maker continued to extend credit to the payee in anticipation of a set-off. The court there observed:

[A]ny one who purchases a note not governed by the law merchant, should at once notify the maker of the change of ownership, if he desires to be protected from defenses afterward acquired by the maker; and the maker of the note is thus placed upon his guard and warned not to extend credit to the payee, upon the supposition that the same will be a credit upon his contract when the time for settlement arrives.

*Id.* at 249-50, 47 N.E. at 842.

<sup>116</sup>See *Morris*, *supra* note 111, at 155.

holder not in due course.<sup>117</sup> Citing section 3 of the 1861 Act, they presumed that such a set-off, if valid at the time of the transfer, "constitutes such a defense that it will not be cut off."<sup>118</sup> The authors also stated that a set-off acquired by the maker against a transferor after the transfer but before notice to the maker could not be raised against the new holder.<sup>119</sup>

In an analysis of the availability of set-off under both the NIL and the UCC, another commentator observed a lack of uniformity among the states.<sup>120</sup> He concluded that, unless a separate statute provides otherwise, set-off should not be available against a holder not in due course.<sup>121</sup> The only possible exception mentioned was where the set-off had matured before the transfer and notice thereof to the maker. However, this commentator failed to distinguish between the otherwise negotiable instrument and the overdue negotiable instrument, only the latter being within the coverage of the NIL.

The overdue negotiable/otherwise negotiable instrument distinction as to set-off has not been addressed by the Indiana courts since the adoption of the UCC. An analogous problem arose under section 58 of the NIL<sup>122</sup> in *Fox v. Terre Haute National Bank*,<sup>123</sup> where the payee of a note brought suit against the accommodation maker. The accommodation maker claimed that he had been discharged when the true maker and the payee, who knew of the defendant's accommodation status, agreed to an extension of time without notifying the defendant. Quoting section 58 of the NIL, which subjects a holder not in due course to the same defenses as if the note were not negotiable,<sup>124</sup> the court observed that after the word "defenses" should be read "existing at the time of its execution or arising out of the original transaction."<sup>125</sup> The court would allow a defense such as lack of consideration, but not a defense which arose subsequent to the creation of the note and out of a separate transaction, such as the defense in the case.<sup>126</sup>

Courts in other jurisdictions have considered this problem under the UCC, but the only point on which the cases generally agree is that state law prior to the adoption of section 3-306 will determine whether a holder

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<sup>117</sup>See PRATTER & TOWNSEND, *supra* note 28, § 3-306 comments.

<sup>118</sup>*Id.*

<sup>119</sup>*Id.*

<sup>120</sup>Morris, *supra* note 111, at 141.

<sup>121</sup>*Id.* at 162.

<sup>122</sup>This section was formerly codified at IND. CODE ANN. § 9089f2 (Burns 1914). "In the hands of any holder other than a holder in due course, a negotiable instrument is subject to the same defenses as if it were non-negotiable." *Id.*

<sup>123</sup>78 Ind. App. 666, 129 N.E. 33 (1920).

<sup>124</sup>*Id.* at 678, 129 N.E. at 37.

<sup>125</sup>*Id.*

<sup>126</sup>*Id.* Although the court acknowledged the statutory language that the defenses should be those available as if the note was not negotiable, the court made no reference to the 1861 Act.

not in due course who is subject to defenses will also be subject to set off,<sup>127</sup> thus assuring that there will be no national uniformity because of the differing state laws prior to the adoption of the UCC.

The inference from the Indiana cases is that otherwise negotiable instruments, which were never negotiable under the law merchant, and overdue negotiable instruments, which were negotiable by definition, are to be treated differently. The former are controlled by section 3 of the 1861 Act and, therefore, are subject to set-off existing prior to notice of the transfer. The latter are subject only to set-off which existed at the time of the transaction giving rise to the instrument. Once again, however, the cases lack precision.

In *Hankins v. Shoup*,<sup>128</sup> the court rejected the contention of the maker that the predecessor to section 3 of the 1861 Act made collateral set-off available against the indorsee of a negotiable instrument which was

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<sup>127</sup>See Note, *Prior Party Set-Off as Defense under U.C.C. Section 3-306(b)*, 1981 U. ILL. L. REV. 869, in which the author acknowledges that the issue presently is determined in the various states according to the law preceeding the NIL. To avoid the lack of uniformity caused thereby the author suggests that the courts look to current contract law. *Id.* at 889-95. In one leading case, *United Overseas Bank v. Veneers, Inc.*, 375 F. Supp. 596 (D. Md. 1974), as a matter of Maryland law under UCC § 3-306, the maker was not permitted to set off a collateral claim against a prior holder in an action on a negotiable note brought by a current holder not in due course. Since § 58 of the NIL, the predecessor to § 3-306, dealt only with "defenses," the court determined that § 58 would have no effect on the earlier state law as to the availability of set-off in a suit on a negotiable instrument. 375 F. Supp. at 607-08. In the absence of any Maryland decision on point, the court relied on the Virginia interpretation of § 58 in *Stegal v. Union Bank & Fed. Trust Co.*, 163 Va. 417, 176 S.E. 438 (1934). The court concluded that under the pre-NIL Maryland law, prior party set-off was available only against the transferee of a non-negotiable instrument, but not against the transferee (holder not in due course) of a negotiable instrument. 375 F. Supp. at 609. A similar conclusion based on Missouri law was reached in *Bank of Wyandotte v. Woodrow*, 394 F. Supp. 550, 555-56 (W.D. Mo. 1975), in which defendant drawers unsuccessfully attempted to assert claims arising from separate transactions with the payees in an action on a check by a mere holder. Because it concluded that any holder of a negotiable instrument, whether in due course or not, would not be subject to prior party set-off, the court did not reach the question whether the holder in fact held in due course. *Id.* at 556. See also *Olsen-Frankman Livestock Mktg. Serv. v. Citizens Nat'l Bank*, 605 F.2d 1082 (8th Cir. 1979) (prior party set-off available against one not a holder in due course both before and after the NIL under Minnesota law); *Srochi v. Kamensky*, 118 Ga. App. 182, 162 S.E.2d 889 (1968) (holder of overdue negotiable instrument takes subject only to equities arising on the instrument under Georgia law). *But see* *Litcher v. North City Trust Co.*, 111 Pa. Super. 1, 169 A. 409 (1933) (holding that NIL § 58 had repealed prior law of set-off and that set-off was available against a holder not in due course). *Cf.* Britton, *supra* note 111, at 437; Note, *supra* note 127. The Indian law of set-off prior to the NIL consisted of § 3 of the 1861 Act and a general set-off statute. The statute provided that in an action on a contract right *not assigned by indorsement*, the assignor must be made a party defendant, and that actions by assignees would be subject "to any set-off, or other defense existing at the time of, or before notice of the assignment." IND. CODE ANN. § 2-226 (Burns 1946) (repealed 1963).

<sup>128</sup>2 Ind. 342 (1850).

overdue. The court observed that had section 3 stood alone, prior party set-off would have been an appropriate defense in a suit on the overdue negotiable note. However, the predecessor to section 6 of the 1861 Act provided that the law merchant should be unaffected as to certain promissory notes, and that the note in question was such a note. Under the law merchant, the court ruled, the holder of an overdue negotiable instrument took free of any set-off between the maker and the payee which did not arise from the note transaction.<sup>129</sup>

In an action by the transferee of an overdue negotiable note, the Indiana Supreme Court observed that if a payee holds a note until it is overdue, this is notice to subsequent takers that there may be *equities* in favor of the maker to which the note is subject.<sup>130</sup> The maker, therefore, was allowed to raise the defense of lack of consideration. In view of the Indiana position that set-off is essentially statutory, rarely equitable,<sup>131</sup> and distinct from genuine defenses on the instrument itself, prior party set-off should not be available against the holder of an overdue negotiable instrument. Thus, at least as to an overdue negotiable instrument, it appears that the indorsee after maturity who cannot hold in due course will be subject only to a set-off between the maker and prior parties which arose from the transaction in which the instrument was created. Subsequent collateral set-offs should not be available.

The position of the holder of an otherwise negotiable instrument is not as secure as that of the holder of an overdue negotiable instrument, primarily because the otherwise negotiable instrument was not negotiable under the law merchant and did not acquire any characteristics of negotiability, in the complex sense, until the adoption of section 3-805 of the UCC.<sup>132</sup> In *Louisville, Evansville & St. Louis Railway Co. v. Caldwell*,<sup>133</sup> the court declared that the absence of words of negotiability from a bill of exchange did not make it any less negotiable under section 1 of the 1861 Act, even if it were not negotiable under the law merchant. The court, however, was concerned with other issues and did not discuss

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<sup>129</sup>*Id.* at 343-44. *Accord* Proctor v. Cole, 115 Ind. 15, 17 N.E. 189 (1888); cf. J. BYLES, A TREATISE ON THE LAW OF BILLS OF EXCHANGE, PROMISSORY NOTES, BANK-NOTES AND CHECKS 266-67 (6th Am. ed. 1874); J. OGDEN, THE LAW OF NEGOTIABLE INSTRUMENTS 157 (2d ed. 1922). See generally Annot., 70 A.L.R. 245 (1931).

<sup>130</sup>First Nat'l Bank v. Henry, 156 Ind. 1, 10, 58 N.E. 1057, 1060 (1900).

<sup>131</sup>See *supra* note 101 and accompanying text. In *Green v. Louthain*, 49 Ind. 139 (1874), the court did state that "[i]t is well settled, that the plaintiff, having acquired title to the note after its maturity and dishonor, holds the same subject to all defenses which could be made to an ordinary promissory note." *Id.* at 141. The issues involved, however, were typical defenses—lack of consideration and usury—rather than set-offs.

<sup>132</sup>U.C.C. § 3-305 official comment; Britton, *Formal Requisites of Negotiability—The Negotiable Instruments Law Compared with the Proposed Commercial Code*, 26 ROCKY MTN. L. REV. 1, 3 (1953); Note, *supra* note 15, at 214.

<sup>133</sup>98 Ind. 245 (1884).

defenses or set-off.<sup>134</sup> Nevertheless, the clear implication is that the otherwise negotiable instrument was treated as a non-negotiable instrument for law merchant purposes, will be controlled by section 3 of the 1861 Act, and may therefore be subject to prior party set-off arising prior to notice of transfer.

Both fairness and reasonable expectations support the assumption of Professors Pratter and Townsend that set-offs in existence at the time of the transfer will not be cut off, as well as their suggestion that the maker's set-offs acquired against the transferor after transfer should not be available in an action by the transferee.<sup>135</sup> While this may be correct as to overdue negotiable instruments, examination of the 1861 Act and the cases thereunder casts serious doubt on whether their assumption, appropriate though it may be, is correct as to the otherwise negotiable instrument.

3. *Estoppel*—As noted earlier in connection with claims of title, an important limitation on the rights of the maker or indorser of a non-negotiable instrument arises from the principle of estoppel.<sup>136</sup> Representations by the maker to a prospective purchaser that the instrument is good, is not subject to any defenses or set-offs, and will be paid when due will preclude the maker from subsequently asserting defenses or set-offs when the purchaser seeks to collect on the instrument.<sup>137</sup> This is so even if the maker was unaware of the defense when he made the representation.<sup>138</sup> Thus, makers have been precluded from raising such otherwise assertable personal defenses as breach of warranty,<sup>139</sup> alteration,<sup>140</sup> and fraud.<sup>141</sup>

A representation by the maker made after the purchaser acquires the instrument, absent other factors such as detrimental reliance on such representation, will not estop the maker from asserting his defense or set-off at the time the non-negotiable instrument falls due.<sup>142</sup> However, an agreement by the holder to extend the time for payment to a specific

<sup>134</sup>The court was primarily concerned with the presumption of consideration which negotiable instruments enjoy. *Id.* at 251-52.

<sup>135</sup>See *supra* notes 117-19 and accompanying text.

<sup>136</sup>See *supra* note 92.

<sup>137</sup>See, e.g., *Krathwohl v. Dawson*, 140 Ind. 1, 3, 38 N.E. 467, 468 (1894); *Hoover v. Kilander*, 83 Ind. 420, 421 (1882); *Stutsman v. Thomas*, 39 Ind. 384, 390 (1872); *Musselman v. McElhenny*, 23 Ind. 4, 6 (1864); cf. *Negotiability by Contract*, *supra* note 91, at 209-10; *Recent Important Decisions, Bills and Notes—Estoppel in Non-Negotiable Note Allowing Holder Same Rights as if Notes Were Negotiable*, 27 MICH. L. REV. 332 (1929).

<sup>138</sup>See *Plummer v. Farmers Bank*, 90 Ind. 386 (1883).

<sup>139</sup>See *Rose v. Teeple*, 16 Ind. 37 (1861) (sale of sheep); *Sloan v. Richmond Trading & Mfg. Co.*, 6 Blackf. 175 (Ind. 1842) (sale of liquor).

<sup>140</sup>See *Krathwohl v. Dawson*, 140 Ind. 1, 3, 38 N.E. 467, 468 (1894) (sale of land).

<sup>141</sup>See *Sloan v. Richmond Trading & Mfg. Co.*, 6 Blackf. 175 (Ind. 1842) (sale of sheep).

<sup>142</sup>See, e.g., *Hoover v. Kilander*, 83 Ind. 420, 421 (1882); *Stutsman v. Thomas*, 39 Ind. 384, 390 (1872).

date in response to the maker's promise to pay on that date has been held to constitute a new promise to pay, and the maker will be estopped from asserting any defenses or set-offs which would have been good had the holder not extended the time for payment.<sup>143</sup>

Thus, by his own conduct or representations, the maker or drawer can create an estoppel which will give the holder of a non-negotiable instrument a position as strong as that of a holder in due course of a negotiable instrument under the UCC.

### C. *Liability of the Indorser to the Holder*

The extent of the liability of an indorser of a non-negotiable instrument under the 1861 Act lies somewhere between the liability of an indorser under the UCC and that of a mere assignor of a contract right.

1. *Liability Under the UCC.*—The indorser's engagement under the UCC, whether he indorses a negotiable, otherwise negotiable or overdue negotiable instrument, is clear: "Upon dishonor and any necessary notice of dishonor and protest he will pay the instrument according to its tenor at the time of his indorsement."<sup>144</sup> Dishonor occurs when, upon presentment, the maker refuses to pay for any reason whatsoever.<sup>145</sup> Once the maker of an instrument covered by the UCC refuses to pay, because he believes he has a valid defense or for any other reason, the holder has an immediate right against the indorser and may proceed directly against him without any further action against the maker.<sup>146</sup>

The non-indorsing transferor under the UCC does not assume the indorser's liabilities, but he does warrant to the transferee that he has good title, that all signatures are authorized, that there have been no material alterations to the instrument, and that there are no defenses good against him.<sup>147</sup>

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<sup>143</sup>See, e.g., *Brown v. First Nat'l Bank*, 115 Ind. 572, 578-79, 18 N.E. 56, 59-60 (1888); *Millett v. Aetna Trust & Sav. Co.*, 70 Ind. App. 451, 457, 122 N.E. 344, 346 (1919); *McCormick Harvesting Mach. Co. v. Yeoman*, 26 Ind. App. 415, 416, 59 N.E. 1069, 1069 (1901).

<sup>144</sup>U.C.C. § 3-414(1).

<sup>145</sup>See *id.* § 3-507(1).

<sup>146</sup>*Id.* § 3-507(2).

<sup>147</sup>See *id.* § 3-417(2). Contrasted to the UCC's transferor is the non-indorsing assignor of a non-negotiable instrument who warrants only that the document or right being assigned is genuine. Unless it is otherwise agreed or understood, he makes no representation whatever concerning the solvency of the obligor or the likelihood that the obligor will pay and is not obligated to pay if the obligor does not. See *McCurdy v. Bowes*, 88 Ind. 583 (1883); *Shirts v. Irons*, 37 Ind. 98 (1871); *Earnest v. Barrett*, 6 Ind. App. 371, 373-74, 33 N.E. 635, 636 (1893); RESTATEMENT (SECOND) OF CONTRACTS § 333 (1981); 3 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 445, at 320-21 (3d ed. 1960). In *Shirts*, the court ruled that a non-indorsing assignor of accounts, which were not within the 1861 Act, did not warrant the solvency of the account debtor. 37 Ind. at 103-04. *McCurdy* cited *Shirts* to this effect, 88 Ind. at 586, but *McCurdy* involved certificates of indebtedness issued by the receiver of an insolvent corporation and the indorsement of those certificates to a third

The UCC also provides that the indorser will be discharged "[w]here without excuse any necessary presentment or notice of dishonor is delayed beyond the time when it is due."<sup>148</sup> A delay in presentment or notice of dishonor will be excused if "caused by circumstances beyond [the holder's] control and [if] he exercises reasonable diligence" thereafter.<sup>149</sup> Presentment and notice are excused entirely if, inter alia, the party to be charged has waived it or has no reason to expect that the instrument will be paid, and presentment is entirely excused if the maker is in insolvency proceedings filed after the instrument was issued.<sup>150</sup>

2. *Liability Under the 1861 Act.*—With an end result similar to that under the UCC, the indorser of a note or draft negotiable under the 1861 Act but not under the law merchant, warrants (1) that the maker is liable on the instrument, *i.e.*, that the maker has no defenses to it, and (2) that the maker will be able to pay it when it comes due.<sup>151</sup> However, unlike the UCC's indorser, this indorser does not warrant that he will pay if the maker merely refuses to pay.

Section 4 of the 1861 Act requires the holder to use "due diligence" prior to suit against any indorser.<sup>152</sup> "The due diligence to be used by the endorsee to obtain the money from the drawer, which our statute requires, is very different from a mere demand upon the drawer, and notice of non-payment to the endorser, according to the custom of merchants."<sup>153</sup> Due diligence under the 1861 Act ordinarily requires the holder first to institute suit against the maker and fail to collect his judgment before proceeding against the indorser.<sup>154</sup>

person. After finding that the certificates were not negotiable instruments, because they lacked an express promise to pay and were payable out of a specific fund, the court concluded that the transfer was a mere assignment without a warranty of solvency. *Id.* at 584-85. The court was most likely referring to the law merchant, because it failed to mention the 1861 Act. Had the court applied the 1861 Act, as it should have, it would have realized that the certificate was negotiable within the Act. Compare *McCurdy* with *Johnson School Township v. Citizens Bank*, 81 Ind. 515 (1882), in which, one year prior to *McCurdy*, the court applied the 1861 Act to a document which stated that "there is due . . . and payable" a sum for school furniture but contained no express promise to pay.

<sup>148</sup>U.C.C. § 3-502(1)(a).

<sup>149</sup>*Id.* § 3-511(1).

<sup>150</sup>*Id.* § 3-511(2), (3).

<sup>151</sup>*See, e.g.*, *Brown v. Nichols, Shephard & Co.*, 123 Ind. 492, 497, 24 N.E. 339, 340 (1890); *Willson v. Binford*, 81 Ind. 588, 594 (1882); *Black v. Duncan*, 60 Ind. 522, 532 (1878); *Clark v. Trueblood*, 16 Ind. App. 98, 100-01, 44 N.E. 679, 679-80 (1896); *cf. Miscellany, Liability of Endorser of Non-Negotiable Paper to Endorsee*, 12 VA. L. REG. 232 (1926). *See generally*, Annot., 79 A.L.R. 719 (1932).

<sup>152</sup>IND. CODE § 26-2-3-4 (1982) ("Any such assignee [read indorsee], having used due diligence in the premises, shall have his action against his immediate or any remote endorser . . .").

<sup>153</sup>*Bullitt v. Scribner*, 1 Blackf. 14, 15 (Ind. 1818); *cf. Comment, Responsibility of an Indorser on a Non-Negotiable Instrument*, 37 YALE L.J. 102 (1927).

<sup>154</sup>*See, e.g.*, *Davis v. Leitzman*, 70 Ind. 275, 278-79 (1880); *Lowther v. Share*, 44 Ind. 390, 391 (1873).



Moreover, suit against the maker is required to be instituted at the earliest opportunity following maturity of the instrument.<sup>155</sup> Current procedure, which permits the filing of suit at any time, would require suit "at the earliest possible time."<sup>156</sup> Thus, although both the UCC and the 1861 Act require the exercise of "diligence" by the holder, in the absence of which the indorser will be discharged, the diligence to be exercised under the 1861 Act requires much more of the holder before he can proceed against the indorser. Furthermore, the joinder of the maker and the indorser as codefendants in the same lawsuit is improper under the 1861 Act because the cause of action against the indorser ordinarily arises only after suit against the maker and an unsuccessful attempt to collect from him.<sup>157</sup>

Just as the UCC excuses diligence in presentment under certain circumstances,<sup>158</sup> due diligence under the 1861 Act does not require suit against the maker where pursuing the maker will cause needless litigation and expense.<sup>159</sup> Suit against the maker is excused, for example, where the maker was insolvent and owned no attachable property as of the time judgment could have been first obtained against him, even if he had had property on the date his note fell due,<sup>160</sup> or was notoriously insolvent

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<sup>155</sup>See, e.g., *Lowther v. Share*, 44 Ind. 390, 391 (1873) ("within a reasonable time"); *Miller v. Deaver*, 30 Ind. 371, 372 (1868); *Huston v. Fatka*, 30 Ind. App. 693, 700, 66 N.E. 74, 76 (1903).

<sup>156</sup>*Matchett v. Anderson Foundry & Mach. Works*, 29 Ind. App. 207, 64 N.E. 229 (1902) (citing *Thompson v. Campbell*, 121 Ind. 398, 23 N.E. 267 (1890)); see also *Huston v. Fatka*, 30 Ind. App. 693, 700, 66 N.E. 74, 76 (1903). In *Thompson*, where the holder knew of the maker's failing economic circumstances, waiting to file suit until the next term of court when suit could properly have been filed at an earlier time was held improper. 121 Ind. at 403, 23 N.E. at 268. The requirement that suit was to be filed in the next term after the due date of the note was based on an old procedural rule which did not permit filing during term time, a rule no longer in effect when the note in *Thompson* fell due. Similarly, in *Roberts v. Masters*, 40 Ind. 461 (1872), the court, acting under the older procedural rule, strictly interpreted the requirement of due diligence and ruled that the holder should have filed suit against the maker on the day after the due date of the note, which happened to be the last day to commence action in the next term. *Id.* at 466-68. The next available term of court did not commence until several months later, and the maker had become insolvent in the interim. Having failed to exercise due diligence against the maker, the holder-indorsee was precluded from recovering against his indorser.

<sup>157</sup>See *Couch v. First Nat'l Bank*, 64 Ind. 92 (1878); *Smith v. Zabel*, 86 Ind. App. 310, 157 N.E. 551 (1927). In *Couch*, the court stated that when notes are negotiable under the law of Indiana, meaning the 1861 Act, but not under the law merchant, "[i]t would seem that makers and endorsers could not be joined in an action, except in cases where the endorsers are liable without a suit having been first brought against the makers." 64 Ind. at 95. This language was repeated in *Smith v. Zabel*, in which the court held that a claim against an indorser could not be raised by the holder as a cross-complaint against the indorser in an action by the maker against the payee-indorsers and the holder to enjoin collection of the note allegedly obtained by fraud. 86 Ind. App. at 321, 151 N.E. at 555.

<sup>158</sup>See U.C.C. § 3-511. See *supra* notes 149-50 and accompanying text.

<sup>159</sup>See *Dick v. Hitt*, 82 Ind. 92, 93 (1882).

<sup>160</sup>See *Reynolds v. Jones*, 19 Ind. 123 (1862). The court found that:

at the time the note fell due and owned no property subject to execution,<sup>161</sup> apparently on the premise that there was little likelihood that he would acquire reachable property by the time judgment could be obtained in the ordinary course. It is not enough that the holder believe he would not be able to recover from the maker; the holder must either proceed with suit against the maker or allege and prove, in his action against the indorser, the maker's insolvency and lack of property.<sup>162</sup>

Prior suit against the maker immediately after maturity of the non-negotiable note also has been excused where the delay in filing suit was at the request of the indorser, usually with the maker becoming insolvent in the interim;<sup>163</sup> where the maker was an infant;<sup>164</sup> where the instrument is invalid as against the maker since such invalidity is a breach of the indorser's warranty of the maker's liability;<sup>165</sup> and where the maker became a non-resident after the assignment of the note but before its maturity,<sup>166</sup> even if the maker left property in Indiana which might have been subject to attachment<sup>167</sup> or returned to Indiana temporarily with attachable property in his possession.<sup>168</sup> The rationale underlying these last excuses is that the holder will not be required to resort to extraordinary or doubtful remedies such as pre-judgment attachment.<sup>169</sup>

3. *Damages Recoverable from Indorser Under the UCC and the 1861 Act.*—Another difference between the indorser's liability under the UCC on any of its three instruments and his liability under the 1861 Act relates to the amount recoverable by the holder in a suit against his indorser. Under the UCC, the indorser engages that upon dishonor of the note he will pay it according to its tenor at the time of his indorsement.<sup>170</sup> Under the 1861 Act, the holder is not automatically entitled to the amount

"Due diligence" does not, in our opinion, require a suit to be brought against the maker in cases where a judgment, obtained as soon as it could be done after the note matured, would be wholly unavailing, because the insolvency of the maker, although he might not have been insolvent at the time the note matured.

*Id.* at 124. In *Reynolds*, there was a lapse of time between the due date of the note and the time when the holder could sue under then existing rules of procedure. The maker had become insolvent in the interim.

<sup>161</sup>See, e.g., *First Nat'l Bank v. Stapf*, 165 Ind. 162, 164, 74 N.E. 987, 988 (1905); *Smythe v. Scott*, 106 Ind. 245, 248-49, 6 N.E. 145, 147 (1886); *Huston v. First Nat'l Bank*, 85 Ind. 21, 25 (1882); *Gwin v. Moore*, 79 Ind. 103, 105 (1881).

<sup>162</sup>See *Guio v. Lutes*, 97 Ind. App. 157, 161, 184 N.E. 416, 418 (1933).

<sup>163</sup>See, e.g., *Davis v. Leitzman*, 70 Ind. 275, 278-79 (1880); *Lowther v. Share*, 44 Ind. 390, 391 (1873); *Sims v. Parks*, 32 Ind. 363, 363-64 (1869).

<sup>164</sup>See *Henderson v. Fox*, 5 Ind. 489, 491 (1854).

<sup>165</sup>*Huston v. First Nat'l Bank*, 85 Ind. 21, 28 (1882) (coverture of maker).

<sup>166</sup>See, e.g., *Stevens v. Alexander*, 82 Ind. 407, 408-09 (1882); *Titus v. Seward*, 68 Ind. 456 (1879); *Bernitz v. Stratford*, 22 Ind. 320, 323 (1864).

<sup>167</sup>See *Bernitz v. Stratford*, 22 Ind. 320, 323 (1864).

<sup>168</sup>See *Titus v. Seward*, 68 Ind. 456 (1879).

<sup>169</sup>See *Brown v. Nichols, Shepard & Co.*, 123 Ind. 492, 496, 24 N.E. 339, 340 (1890).

<sup>170</sup>U.C.C. § 3-414(1).

of the note. Rather, he is entitled only to the amount paid for it plus interest,<sup>171</sup> with the face amount of the note constituting prima facie evidence of the price paid.<sup>172</sup> The indorser, however, may show that the holder paid him less than the face amount and therefore be liable to the holder only for the amount paid.<sup>173</sup> This result is contrary to the expectation interest of the holder who, when he purchases any note at a discount, anticipates that he will receive the face amount of the note regardless of the amount he paid for it as long as he paid a fair price. Nevertheless, the language of the cases, particularly *Youse v. M'Creary*,<sup>174</sup> which is the seminal case, indicates that the 1861 Act is to be so construed. The court there stated:

It appears to us, that where the money can not be obtained from the maker of the note, the consideration which moved from the assignor for whatever he receives for the note, thereby fails; and he should then be liable for the value which he had received from the assignee for that consideration, with interest, and the costs of the suit against the maker. . . . The intention of our statute, making the obligations assignable, will be best answered, as we conceive, by this construction.<sup>175</sup>

#### *D. Liability of Irregular Indorsers and Accommodation Parties*

The UCC defines an accommodation party as "one who signs the instrument in any capacity for the purpose of lending his name to another party to it."<sup>176</sup> This is typically done by the accommodation party to lend his credit to the party being accommodated, and he may sign either as a maker or an indorser. An irregular indorser is a person whose indorsement appears on the back of the instrument in such a position that it is not in the chain of title.<sup>177</sup> Such an indorsement usually appears prior to the indorsement of the payee and frequently precedes the delivery of the instrument to the payee. Under the UCC, such an indorsement constitutes notice of its accommodation status.<sup>178</sup> There appear to be some

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<sup>171</sup>See *Schmied v. Frank*, 86 Ind. 250, 258 (1882); *Huston v. First Nat'l Bank*, 85 Ind. 21, 26 (1882); *Foust v. Gregg*, 68 Ind. 399, 400 (1879); *French v. Turner*, 15 Ind. 59, 62-63 (1860); *Youse v. M'Creary*, 2 Blackf. 243, 245-46 (Ind. 1829).

<sup>172</sup>See *Foust v. Gregg*, 68 Ind. 399, 400 (1879); *Youse v. M'Creary*, 2 Blackf. 243, 245-46 (Ind. 1829).

<sup>173</sup>See *Foust v. Gregg*, 68 Ind. 399, 400 (1879); *Youse v. M'Creary*, 2 Blackf. 243, 245-46 (Ind. 1829).

<sup>174</sup>2 Blackf. 243 (Ind. 1829).

<sup>175</sup>*Id.* at 245-46.

<sup>176</sup>U.C.C. § 3-415(1).

<sup>177</sup>See, e.g., *Horner, Bills and Notes—Liability of Irregular Indorsers of Non-Negotiable Paper*, 3 J. MAR. L.Q. 62 (1937).

<sup>178</sup>U.C.C. § 3-415(4).

important differences between the rights and duties of accommodation parties on UCC-controlled instruments and those of accommodation parties on non-negotiable instruments transferrable by indorsement under the 1861 Act.

The determination that one is an accommodation party, rather than a maker or indorser, will have a significant effect on his rights and duties both to holders of the instrument and to other parties.<sup>179</sup> For example, a true indorser, who is an assignor or transferor, will be required to pay only after presentment and dishonor in the case of a negotiable instrument,<sup>180</sup> and only after the exercise of due diligence in the case of a non-negotiable instrument.<sup>181</sup> An accommodation party, on the other hand, is in the position of a surety and may be proceeded against directly but he may also assert both special suretyship defenses as well as defenses available to his principal.<sup>182</sup>

Unlike the true indorser, the accommodation indorser will not be required to pay if the maker has a valid defense on the instrument. Moreover, in situations where the accommodation party is not permitted to assert his accommodation status as against the holder of the instrument, he may be able to assert his accommodation status against the maker or other accommodation or accommodated parties and to recover from them by way of contribution or subrogation.<sup>183</sup>

Pursuant to subsection 3-415(3) of the UCC, the accommodation party may show his accommodation status by extrinsic evidence in all cases except those involving a holder in due course who has no notice of the accommodation.<sup>184</sup> Other than the appearance on the instrument of language which so indicates, the only indicator on the instrument itself of accommodation status is an indorsement not in the chain of title, i.e., an indorsement of a stranger to the instrument immediately above the indorsement of the payee or named indorsee.<sup>185</sup> Because there can be no holder in due course of an overdue or otherwise negotiable instrument, accommodation status may be shown by extrinsic evidence on either. This

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<sup>179</sup>See generally Annot., 18 A.L.R.3D 647 (1968) (liability of indorser, other than payee or transferee, of non-negotiable instrument).

<sup>180</sup>See *supra* notes 144-46 and accompanying text.

<sup>181</sup>See *supra* notes 152-57 and accompanying text.

<sup>182</sup>See U.C.C. §§ 3-415, 3-416, 3-606, and the official comments thereto; WHITE & SUMMERS, *supra* note 51, at §§ 13-14, 13-16, 13-17.

<sup>183</sup>See authorities cited *supra* note 182.

<sup>184</sup>U.C.C. § 3-415(3). WHITE & SUMMERS, *supra* note 51, at § 13-13. Section 3-415(3) of the UCC states: "As against a holder in due course and without notice of the accommodation oral proof of the accommodation is not admissible to give the accommodation party the benefit of discharges dependent on his character as such. In other cases the accommodation character may be shown by oral proof."

<sup>185</sup>U.C.C. § 3-415(4). "An endorsement which shows that it is not in the [chain] of title is notice of its accommodation character." *Id.*

does not appear to be so with regard to some of the non-negotiable instruments controlled by the 1861 Act.

The pre-UCC and pre-NIL cases involving irregular indorsers, "if not full of confusion and contradiction, are, in many respects, variant and difficult to harmonize."<sup>186</sup> The court in *Pool v. Anderson*<sup>187</sup> attempted to clarify the muddle by restating the rules applicable to irregular indorsements and explaining the underlying basis for those rules. In *Pool*, the defendant had written his name on the reverse side of a non-negotiable promissory note prior to its delivery to the plaintiff-payee. The indorser-defendant argued that his irregular indorsement imposed upon him the liability of an indorser, and that there was no excuse for the payee's failure to exercise due diligence in pursuing the makers.

The *Pool* court reaffirmed the rule as initially explained in *Wells v. Jackson*<sup>188</sup> that the irregular indorser of an instrument not negotiable under the law merchant, in the absence of any extrinsic agreement to the contrary, is a surety or joint promisor, whereas the irregular indorser of an instrument negotiable under the law merchant prima facie has the liability only of an indorser.<sup>189</sup> The court explained that an irregular indorser of a note negotiable under the law merchant undertakes that, if the maker fails to pay at maturity and the indorser is notified of the dishonor, he will pay.<sup>190</sup> However, the court reasoned that since an instrument not negotiable under the law merchant is not mercantile paper and one cannot be an indorser of such an instrument in this commercial sense, irregular indorsement of such an instrument cannot create a similar commercial contract. One ordinarily indorses a non-negotiable note in order to transfer title, thereby warranting the validity of the note, the liability of the maker, the maker's ability to pay, and that the indorser will pay if due diligence against the maker is unsuccessful.<sup>191</sup> But the irregular indorser of non-negotiable paper is not transferring title; he is lending his

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<sup>186</sup>*Kealing v. Vansicle*, 74 Ind. 529, 537 (1881). See *Pool v. Anderson*, 116 Ind. 88, 90-91, 18 N.E. 445, 446 (1888).

<sup>187</sup>116 Ind. 88, 18 N.E. 445 (1888).

<sup>188</sup>6 Blackf. 40 (Ind. 1841).

<sup>189</sup>116 Ind. at 93, 18 N.E. at 447. *Wells* had been overruled in part by *Drake v. Markle*, 21 Ind. 433 (1863), which held that since every promissory note was negotiable under the 1861 Act, an irregular indorser of any promissory note was presumably bound as an indorser. See 116 Ind. at 93-94, 18 N.E. at 447. One of the reasons for this result in *Drake* was, as *Pool* noted, that the court in that case and others had abandoned or overlooked the distinctions between negotiability under the law merchant and under the Act or its predecessors. *Id.* By reaffirming the rule of *Wells v. Jackson* as "logically maintainable, and . . . supported upon principle and authority," *Pool* effectively overruled that portion of *Drake* as to promissory notes not negotiable under the law merchant. *Id.* at 93, 18 N.E. at 447.

<sup>190</sup>*Id.* at 95, 18 N.E. at 448.

<sup>191</sup>*Id.* at 96, 18 N.E. at 448.

name and credit to the maker. Since the note is subject to all of the defenses of the maker under the 1861 Act, the court reasoned that an irregular indorser of non-negotiable paper, who merely lent his credit to the maker, should not be held liable after a successful defense by the maker.<sup>192</sup> The court concluded that such an indorser should be held liable as surety or joint promisor, not as indorser.<sup>193</sup> Because notice of non-payment need not be given to a surety or joint promisor, due diligence or the waiver thereof was not required to be shown. Accordingly, the plaintiff-payee in *Pool* had stated a valid claim against the irregular indorser despite the absence of an allegation that he first exercised due diligence against the maker.<sup>194</sup>

Furthermore, unlike the UCC which permits evidence of accommodation status in all situations except those involving holders in due course without knowledge,<sup>195</sup> cases under the 1861 Act permit extrinsic evidence in an action by the holder to collect only where the indorsement is irregular. In such an action, extrinsic evidence will not be allowed to establish the accommodation status of a party whose signature appears properly in the chain of title or is regularly located.<sup>196</sup> Thus, where the indorsement of the named payee appeared in its proper place on the reverse side of the note,<sup>197</sup> or the indorsement of the alleged accommodation indorser appeared below that of the payee,<sup>198</sup> parol evidence was inadmissible as against the holder to vary the contract of the party claiming accommodation status.

As between the parties on the instrument, extrinsic evidence is admissible to adjust their respective liabilities, whether the instrument is negotiable under the law merchant or not, and whether the signature of the alleged accommodation party is regular or irregular, because the agreement between sureties and principals is collateral to the instrument and not part of it.<sup>199</sup> Consequently, even though a party's signature appears

<sup>192</sup>*Id.* at 96-97, 18 N.E. at 448. *Accord* *Hubbard v. First State Bank*, 67 Ind. App. 47, 60-63, 114 N.E. 642, 646-47 (1917) (the irregular indorser of a non-negotiable note argued unsuccessfully that he was only an indorser and was discharged by the holder's failure to exercise due diligence); *Oyler v. McMurray*, 7 Ind. App. 645, 34 N.E. 1004 (1893) (irregular indorser successfully contended that his position was that of surety and that the extension of time on the note beyond the initial extension to which he had agreed, given without his knowledge, stated a valid defense to the holder's action on the note).

<sup>193</sup>116 Ind. at 96-97, 18 N.E. at 448.

<sup>194</sup>*Id.* at 97, 18 N.E. at 449.

<sup>195</sup>U.C.C. § 3-415(3).

<sup>196</sup>*See, e.g.,* *Stack v. Beach*, 74 Ind. 571, 574 (1881); *Armstrong v. Harshman*, 61 Ind. 52, 54-55 (1877); *Holton v. McCormick*, 45 Ind. 411, 415 (1873); *Snyder v. Oatman*, 16 Ind. 265, 266 (1861); *Vore v. Hurst*, 13 Ind. 551, 557 (1859).

<sup>197</sup>*See* *Holton v. McCormick*, 45 Ind. 411, 415 (1873); *Harshman v. Armstrong*, 43 Ind. 126, 130 (1873).

<sup>198</sup>*See* *Vore v. Hurst*, 13 Ind. 551, 557 (1859).

<sup>199</sup>*See, e.g.,* *Porter v. Waltz*, 108 Ind. 40, 42, 8 N.E. 705, 706 (1886); *Houck v. Graham*, 106 Ind. 195, 199, 6 N.E. 594, 596 (1886); *Horn v. Bray*, 51 Ind. 555, 563-64 (1875); *Schooley v. Fletcher*, 45 Ind. 86, 88-89 (1873).

as that of a maker of the note and there is nothing on the note itself to indicate that he was acting as an accommodation party, he may show that he signed as an accommodation or surety for the other makers of the note,<sup>200</sup> as surety for the makers and co-surety with indorsers,<sup>201</sup> or as surety for the maker and co-surety with the payee-indorsers.<sup>202</sup>

The net effect is that if an instrument appears to be regular, i.e., bears no irregular indorsement or indicative language, the holder in due course of a negotiable instrument and the holder of a non-negotiable instrument will not be subject to suretyship defenses of an alleged accommodation party. The holder of an overdue or otherwise negotiable instrument, however, will be subject to those defenses. Looking at the situation from the perspective of an accommodation party, such a party on a UCC-controlled instrument will always be able to prove his accommodation status as against a holder-plaintiff other than a holder in due course without notice. But the accommodation party on a non-negotiable instrument will be able to prove his status only if he is an irregular indorser. In all cases, however, the relationship of the parties on the instrument *inter se* may be shown by extrinsic evidence. Once again, the holder of the overdue or otherwise negotiable instrument has a less secure position than that of the holder of a non-negotiable instrument.

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<sup>200</sup>See *Porter v. Waltz*, 108 Ind. 40, 8 N.E. 705 (1886).

<sup>201</sup>See *Houck v. Graham*, 106 Ind. 195, 6 N.E. 594 (1886).

<sup>202</sup>See *Harshman v. Armstrong*, 43 Ind. 126 (1873). In *Harshman*, the original maker persuaded one party to co-sign as maker and the other parties to sign as indorsers before the names of the payees had been inserted. The original maker then inserted the indorsers' names as payees. Because the parties appeared in their regular positions on the note, the court observed that the subsequent indorsee could not have maintained an action against the payees as co-sureties. *Id.* at 130. But the actual relationship between the parties themselves, in this action for contribution, could be shown by parol evidence. *Id.* at 130-31. The court ruled that the complaint did state a cause of action in favor of the accommodation maker against the payee-indorsers and remanded the case for trial. In a second appeal involving the same promissory note, *Armstrong v. Harshman*, 61 Ind. 52 (1878), the court cast serious doubt on its earlier ruling when it said that "parol evidence can not be given to show, that, by thus placing their names upon the note, they [the payee-indorsers] intended to contract a different liability from that which the law attaches to the contract as made by them." *Id.* at 55. However, the court's decision was based on the determination that there had been no evidence of an agreement that the payees would be co-sureties with the accommodation maker and that the theory on which the case had been tried, that there need be no such agreement, was incorrect. *Id.* at 55-56. The court did not actually decide the extrinsic evidence issue nor was it called upon to do so. See *Houck v. Graham*, 106 Ind. 195, 199, 6 N.E. 594, 597 (1886). And when the case came before the court a third time, *Armstrong v. Harshman*, 93 Ind. 216 (1883), after the trial court found on the evidence that the payee-indorsers had agreed to be co-sureties with the accommodation maker, the supreme court affirmed entry of judgment against the payee-indorsers. The court stated that with respect to the second appeal, "it was held that the evidence was not sufficient as to an express contract," *id.* at 218, thus supporting the conclusion in *Houck* that the second decision on appeal did not affect the prevailing rule as to the relationship between parties to an instrument.

## IV. OBSERVATIONS AND RECOMMENDATIONS

With the 1861 Act creating rights and duties different from those created by both the UCC and the common law, what justification was there for retention of the Act? The expressly stated purposes of the UCC are "to simplify, clarify and modernize the law governing commercial transactions; to permit continued expansion of commercial practices . . . ; [and] to make uniform the law among the various [states]."<sup>203</sup> Why, in 1963, would a state legislature, intent on modernizing the law of negotiable instruments by replacing the fifty-year-old NIL with a new UCC, perpetuate the existence of a century-old statute whose antecedents date back to 1818 in Indiana and to a British statute enacted in 1704 as a codification of the then prevailing law merchant?

In the absence of Indiana legislative history, the only answer the author has been able to discover is, according to a leader in the movement to adopt the UCC in Indiana, a desire to preserve the concept of the "quasi-negotiable" instrument.<sup>204</sup> One scholar has described this reasoning as follows:

The phrase "*quasi negotiable*" has been termed an unhappy one; and certainly it is far from satisfactory, as it conveys no accurate, well-defined meaning. But still it describes better than any other shorthand expression the nature of those instruments which, while not negotiable in the sense of the law merchant, are so framed and so dealt with, as frequently to convey as good a title to the transferee as if they were negotiable.<sup>205</sup>

In the great majority of cases, the concept of quasi-negotiability has been applied to such things as corporate or government securities,<sup>206</sup> documents

<sup>203</sup>U.C.C. § 1-102(2).

<sup>204</sup>Interview with R. Bruce Townsend, Cleon H. Foust Professor of Law (now emeritus), Indiana University School of Law—Indianapolis, Spring, 1982. Professor Townsend was involved in the final stages of drafting the Uniform Commercial Code and was an important force in the adoption of the UCC in Indiana. For an exhaustive and definitive comparison of the prior Indiana law with the then newly proposed UCC, see PRATTER & TOWNSEND, *supra* note 28.

<sup>205</sup>J. DANIEL, A TREATISE ON THE LAW OF NEGOTIABLE INSTRUMENTS § 2093 (7th ed. 1933) (footnote omitted). *Accord* National Bank of Savannah v. Kershaw Oil Mill, 202 F. 90, 94 (4th Cir. 1912).

<sup>206</sup>See, e.g., First Nat'l Bank v. Mayor & City Council of Baltimore, 27 F. Supp. 444, 452-53 (D. Md. 1939), *aff'd*, 108 F.2d 600 (4th Cir. 1940) (city's certificates of indebtedness); Real-Estate Trust Co. v. Bird, 90 Md. 229, 231, 44 A. 1048, 1050 (1899) (corporate stock); Austin v. Hayden, 171 Mich. 38, 50, 137 N.W. 317, 322 (1912) (corporate stocks and bonds); 3 J. DANIEL, *supra* note 204, at § 2093; Aigler, *Recognition of New Types of Negotiable Instruments*, 24 COLUM. L. REV. 563, 584-85 (1924); Elliott, *Negotiability of Highway Improvement Bonds*, 2 IND. L.J. 264 (1926); *Good Faith Purchase*, *supra* note 24, at 1072-73; *Confessions*, *supra* note 24, at 610; Note, *Estoppel—Non-Negotiable Instruments—Bona Fide Purchase of County Warrants Endorsed in Blank—Reliance on Indicia of Ownership*, 8 MINN. L. REV. 526, 528-29 (1924).



of title (warehouse receipts and bills of lading),<sup>207</sup> and consumer paper.<sup>208</sup> This is usually because of common law development, specifically directed statutory provisions,<sup>209</sup> or self-contained language.<sup>210</sup> In the modern commercial context, most, if not all, of the paper classified as quasi-negotiable is regulated by specifically applicable statutes,<sup>211</sup> rather than by legislation of general applicability such as the 1861 Act.

When the NIL was in effect, instruments were either negotiable or not. There was no in-between area for instruments not quite meeting the NIL requirements for negotiability.<sup>212</sup> Nevertheless, a concept of quasi-negotiability was apparently necessary for those instruments intended to be reasonably freely transferrable in the commercial context and to effectuate the statutory or contractual provisions making them so, but not necessarily to the point of granting holder in due course status.<sup>213</sup>

The adoption of the UCC, particularly sections 3-104 and 3-805, has changed the all or nothing position of the NIL and has created the UCC's own quasi-negotiable instrument in the form of the otherwise negotiable

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<sup>207</sup>See, e.g., *National Bank of Savannah v. Kershaw Oil Mill*, 202 F. 90, 94 (4th Cir. 1912) (bills of lading); 3 J. DANIEL, *supra* note 205, at §§ 2060, 2083-92, 2112 (the last section dealing with warehouse receipts, the balance with bills of lading); Aigler, *supra* note 206, at 584-85; *Good Faith Purchase*, *supra* note 24, at 1076-81; *Confessions*, *supra* note 24, at 610.

<sup>208</sup>See, e.g., *Good Faith Purchase*, *supra* note 24, at 1093-1107; Comment, *Partial Negotiability of Irregular Instruments*, 33 YALE L.J. 302 (1924); cf. Kripke, *Chattel Paper as a Negotiable Specialty under the Uniform Commercial Code*, 59 YALE L.J. 1209 (1950).

<sup>209</sup>E.g., The Uniform Stock Transfer Act, The Uniform Bills of Lading Act, The Uniform Warehouse Receipts Act, The Uniform Conditional Sales Act (all of which have been superseded by the UCC). See 3 J. DANIEL, *supra* note 205, at § 2102; *Good Faith Purchase*, *supra* note 24, at 1075-81; *Confessions*, *supra* note 24, at 610. In *Aetna Trust & Sav. Co. v. Nackenhorst*, 188 Ind. 621, 630, 122 N.E. 421, 424 (1919), the court noted that the sewer assessment bonds involved had been made negotiable as inland bills of exchange by specific statutory provision. Similarly, in *Farmers' Bank v. Orr*, 25 Ind. App. 71, 80, 55 N.E. 35, 38 (1899), gravel road certificates had been made assignable as promissory notes by statute.

<sup>210</sup>See Comment, *supra* note 208, at 308.

<sup>211</sup>See, e.g., UCC Articles 7 (warehouse receipts and bills of lading), 8 (corporate securities) and 9 (secured transactions, including chattel paper). See generally Kripke, *supra* note 208.

<sup>212</sup>See Britton, *supra* note 132 (the NIL required that an instrument *must* comply with its terms to be negotiable).

<sup>213</sup>One author observed that, notwithstanding the total occupation of the field of negotiable instruments by the NIL, the quasi-negotiability of promissory notes payable in specifics such as farm crops, although not negotiable under the NIL and "a generally undesirable type of commercial paper," was "very helpful in farm financing" in Georgia. Culp, *supra* note 8, at 292. Notes used for such purposes today would probably be governed by the secured transactions provisions of the UCC Article 9. See also Francis, *Do Some of the Major Postulates of the Law of Bills and Notes Need Re-Examination?* 14 CORNELL L.Q. 41, 47-48 (1928), where the author suggests that "hop checks," a form of scrip given to pickers of hops as payment for their work, would probably have been held negotiable, notwithstanding the NIL, because of the manner in which the pickers dealt with them.

instrument. This particular development was somewhat controversial, with some commentators condemning the departure from the rigidity and certainty of the NIL and others praising it.<sup>214</sup> One author has suggested that the UCC did not go far enough and should apply to all instruments, negotiable or not,<sup>215</sup> thus echoing a much earlier suggestion that the move should be away from a distinction between negotiable and non-negotiable instruments.<sup>216</sup> More recently, there have been challenges directed to the entire concept of negotiability.<sup>217</sup>

Regardless of the UCC's perceived merits or defects, it clearly evidences an intention to liberalize the availability of some characteristics of negotiability to instruments or documents outside its purview, ostensibly by common law development, perhaps by development of a new law merchant. By retaining the 1861 Act, however, the Indiana legislature has evidenced an intention to make such characteristics available by statute rather than by leaving the developments entirely to the growth of the common law through a new law merchant. Having opted to preserve the concept of quasi-negotiability for instruments presently outside the pale of the UCC, there seems to be no good reason why the transfer of such instruments cannot be governed by the same rules which govern the transfer of overdue and otherwise negotiable instruments within the UCC. In this way, parties to a non-negotiable instrument will possess the same rights and liabilities as parties to overdue or otherwise negotiable instruments, thereby endowing the applicable law with more certainty and eliminating the disadvantages suffered by some instruments under the UCC when compared with instruments under the 1861 Act.

Accordingly, the author suggests that the 1861 Act be repealed and replaced with a statute which states merely:

All instruments in writing, signed by any person, in which said person promises to pay money or acknowledges money to be due, and which does not comply with the requirements of negotiability set forth in the Uniform Commercial Code, shall be transferrable pursuant to the rules established by the Uniform Commercial Code, except that there shall be no holder in due course of such instruments.<sup>218</sup>

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<sup>214</sup>Compare Britton, *supra* note 132, at 1-4 (while generally praising the new Article 3, decrying the UCC's move away from the rigid policy of the NIL toward a more liberal policy of making instruments lacking words of negotiability "semi-negotiable,") with Good Faith Purchase, *supra* note 24, at 1107-08 (lamenting the "strait-jacket" created by the NIL and praising the UCC's more liberal approach).

<sup>215</sup>See Note, *supra* note 15, at 223.

<sup>216</sup>See Goodrich, *supra* note 50, at 85.

<sup>217</sup>See Rosenthal, *Negotiability—Who Needs It?* 71 COLUM. L. REV. 375 (1971). Even Gilmore questioned the doctrine of negotiability and the creation of a holder in due course. See *Confessions*, *supra* note 24, at 619.

<sup>218</sup>As noted at the outset, § 1 of the 1861 Act also applies to promises to deliver or

By replacing the 1861 Act with such a provision the legislature truly will have modernized the law applicable to commercial transactions while at the same time preserving the concept of quasi-negotiability within the most effective rules developed to date.

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convey property or to perform acts. *See supra* note 36. There appears no need to preserve quasi-negotiability of such promises by a statute of general application in view of the specific statutes now applicable. *See supra* note 209 and accompanying text. Instruments containing such promises not subject to specific statutory control would just as well be served by the continually developing common law of assignment and delegation.

