1996 SURVEY OF THE UNIFORM COMMERCIAL CODE IN INDIANA

HAROLD GREENBERG*
KATHLEEN PATCHEL**

INTRODUCTION

This Survey summarizes and comments on recent developments of special interest affecting the Uniform Commercial Code in Indiana.[1] Although particular attention has been paid to cases decided by Indiana state courts and by federal courts applying Indiana law, Seventh Circuit cases dealing with issues not yet clearly addressed by the Indiana courts also have been included.

I. ARTICLE 2—SALES

A. Additional Terms, the "Battle of the Forms" Under U.C.C. Section 2-207 and Usage of Trade

U.C.C. section 2-207 has been a fertile source of litigation relating to the "battle of the forms," as the cases in this Survey readily demonstrate. One Indiana case in the ongoing skirmishes, *Wilson Fertilizer & Grain, Inc. v. ADM Milling Co.*,[2] yielded the somewhat unhappy result of allowing a buyer to keep goods without paying for them.[3] ADM Milling purchased grain from Wilson Fertilizer & Grain. The court stated that the contract between the parties was "facilitated" by a broker who sent each party a confirmation, but the opinion is unclear as to what this means. The broker's confirmations did not mention arbitration. The buyer also sent its own confirmation directly to the seller. The buyer's confirmation said nothing about arbitration or any limitation of action, but did contain "boiler plate language which state[d]: 'This contract is also subject to the

---

* Professor of Law, Indiana University School of Law—Indianapolis. A.B., Temple University; J.D., University of Pennsylvania. Professor Greenberg is primarily responsible for the sections of this Survey discussing Articles 2 and 5.

** Associate Professor of Law, Indiana University School of Law—Indianapolis. A.B., Huntingdon College; J.D., University of North Carolina at Chapel Hill; LL.M., Yale Law School. Professor Patchel is a member of the American Law Institute Consultative Groups for Articles 2 and 9 and Assistant to the Reporter for the Article 1 Drafting Committee. Professor Patchel is primarily responsible for the sections of this Survey discussing Articles 3, 4 and 9.

1. IND. CODE §§ 26-1-1-101 to -9-507 (1993 & Supp. 1996). Unless the Indiana version of the Uniform Commercial Code differs from the Official Draft, citation will be to the Uniform Act, rather than to sections of the Indiana Code. (E.g., U.C.C. § 2-207 rather than IND. CODE § 26-1-2-207.) Citation to the Uniform Commercial Code of other states will be to the Uniform Act as well.

2. 654 N.E.2d 848 (Ind. Ct. App. 1995), *trans. denied*. *Wilson* was briefly summarized in last year's Survey. *See* Comment, *1995 Survey of Indiana Commercial Code*, 29 IND. L. REV. 1127, 1131-33 (1996).

3. *See Wilson*, 654 N.E.2d at 855 (Kirsch, J., concurring in part and dissenting in part) (characterizing the result in *Wilson* as a game of "Legal Gotcha" won by the buyer).

Trade Rules of the National Grain and Feed Association currently in effect.'"[4] Included in these trade rules were an arbitration provision and a limitation period of one year. When ADM failed to pay and Wilson sued, the trial court granted ADM's motion to dismiss based on the trade rules arbitration provision.

On appeal, the parties agreed that they had a contract, that they were both merchants, and that the provisions in ADM's form were additional terms. The issue for resolution was whether the additional terms materially altered the contract so as not to become part of it pursuant to U.C.C. section 2-207(2)(b).[5]

At the outset of its analysis, the court correctly observed that the test of whether an additional term constitutes a material alteration under U.C.C. section 2-207(2)(b) is whether its "incorporation into the contract without express awareness by the other party would result in surprise or hardship."[6] In rejecting Wilson's argument that an arbitration clause is a material alteration as a matter of law, the court refused to adopt the New York rule that an additional arbitration clause is a material alteration per se.[7] Instead, the court concluded that whether an arbitration clause (or any other term) constitutes a material alteration is a question of fact, dependent on the circumstances of each case.[8]

Having taken the position that it is a question of fact whether an arbitration clause constitutes a material alteration that causes undue surprise or hardship, the court correctly placed the burden of proving that fact on Wilson in this case, as the party who was seeking to avoid enforcement of the term. The burden of proving the existence of a trade usage to arbitrate, however, and that of establishing Wilson was bound by the trade usage because it was "in the trade," should have been

---

4. *Id.* at 849.

5. Section 2-207 provides in pertinent part:

> (1) A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.
>
> (2) The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:
>
> (a) the offer expressly limits acceptance to the terms of the offer;
>
> (b) they materially alter it; or
>
> (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.

U.C.C. § 2-207(1)-(2).

6. *Wilson*, 654 N.E.2d at 850 (quoting Maxon Corp. v. Tyler Pipe Indus., Inc., 497 N.E.2d 570, 576 (Ind. Ct. App. 1986)).

7. *Id.* at 852. The New York rule, with which U.C.C. scholars White & Summers agree, also provides that if usage of trade calls for arbitration, that usage is incorporated into the original agreement and thus its presence in the last form to be sent would not constitute a material alteration. *See* 1 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 1-3, at 27-28 (4th ed. 1995).

8. *Wilson*, 654 N.E.2d at 852 (citing Luedtke Eng'g Co. v. Indiana Limestone Co., 740 F.2d 598, 600 (7th Cir. 1984)).

placed on ADM as the party seeking to apply the trade usage. Both issues should have been determined in an evidentiary hearing rather than by the trial court itself upon argument of counsel on a motion to dismiss. The court of appeals sidestepped this issue by stating: "As was the trial court, we are unpersuaded by Wilson's argument that it should not be made to bear the burden of objecting to the additional terms in the contract or inquiring as to provisions incorporated by reference."[9]

By suggesting that Wilson should have read and objected to the unfavorable term, the court demonstrated both the philosophy underlying its decision and a misunderstanding of the policy and application of section 2-207. The court ignored its own statement earlier in its opinion that the issue was whether incorporation of the term "'*without express awareness by the other party* would result in surprise or hardship.'"[10] The issue is not whether Wilson should have read the form, as it would have been if there were a single form signed by both parties and Wilson objected to a term he had not read before signing. Rather, the issue is whether, after there was a contract between the parties, the term added by ADM's form would cause unfair surprise or hardship to Wilson, who was unaware of the additional term. Wilson's failure to read and object is irrelevant to this inquiry. The court's approach would read section 2-207(2)(b) out of the statute: if the recipient of a form must always read the boilerplate and object to it, as the court seems to assume, there would be no need for the "material alteration" language of section 2-207(2)(b).[11] As the First Circuit recently observed,

> The reality of modern commercial dealings . . . is that not all participants read their forms. The sender of the last form . . . could insert virtually any conditions it chooses into the contract, including conditions contrary to those in the initial form. The final form, therefore, would give its sender the power to re-write the contract[, which is contrary to the philosophy of U.C.C. section 2-207.][12]

Judge Kirsch's opinion in *Wilson*, concurring in part and dissenting in part,

---

9. *Id.* at 854.

10. *Id.* at 850 (quoting Maxon Corp. v. Tyler Pipe Indus. Inc., 497 N.E.2d 570, 576 (Ind. Ct. App. 1986)) (emphasis added).

11. The *Wilson* court lavishes praise on the farmer in *Continental Grain Co. v. Followell*, 475 N.E.2d 318 (Ind. Ct. App. 1985), who in fact did read and object. *Wilson*, 654 N.E.2d at 854-55. The *Followell* decision, however, is seriously flawed. *See* Harold Greenberg, *Recent Developments in Indiana Commercial Law*, 28 IND. L. REV. 1125, 1127-34 (1995). Moreover, *Followell* is irrelevant to *Wilson*. The *Followell* court treated the issue as one involving an *offer* followed by a response that did not operate as an acceptance so as to form a contract. In *Wilson*, the issue involved one party adding a term to an *already existing* contract.

12. Ionics, Inc. v. Elmwood Sensors, Inc., 110 F.3d 184, 189 (1st Cir. 1997). *Ionics* overruled *Roto-Lith, Ltd. v. F.P. Bartlett & Co.*, 297 F.2d 497 (1st Cir. 1962), a case upon which *Followell* expressly relied. Although *Ionics* involved an exchange of forms with directly contradictory terms, its approach to section 2-207 applies equally well to *Wilson*, in which there was an oral agreement followed by an additional term not read by the recipient seller.

has the better position: the court's statement of the law may have been correct, but it was inappropriate to dismiss the action without an evidentiary hearing on crucial issues of fact, particularly whether Wilson, who was unfamiliar with and did not read either the trade rules or the language incorporating them, was unfairly surprised by ADM's attempt to incorporate them into the contract.[13]

B. More Additional Terms and the Battle of the Forms

The parties in *Waukesha Foundry, Inc. v. Industrial Engineering Inc.*[14] were engaged in an ongoing relationship in which buyer would order and seller would manufacture to buyer's specifications castings used in the production of television picture tubes. Seller's acknowledgment forms to sixty orders over four years,[15] as well as hundreds of packing slips and invoices, contained a disclaimer or modification of warranties, a limitation of remedies exclusively to repair, replacement, or credit, and an exclusion of consequential damages. When the relationship soured due to buyer's financial difficulties, seller sued for payment of outstanding invoices. Buyer counterclaimed for consequential damages allegedly suffered as a result of seller's delivery of defective castings. At issue was whether the disclaimer of warranties and limitation of remedies, terms admittedly additional to the offer to buy expressed in buyer's order forms, became part of the contract pursuant to U.C.C. section 2-207(2)(b).

Applying Wisconsin law, the Seventh Circuit declared that "[a]n alteration is material if the party against whom it is sought to be enforced would be ambushed by its addition to the contract."[16] The court further reasoned, however, that there must be an examination into the relationship of the parties to determine whether the party who otherwise would be adversely affected by the additional term had accepted that term notwithstanding the arguable ambush. In this case, the court observed, buyer had frequently availed itself of the very remedies set forth in the packing slips and invoices by sending defective castings to seller for replacement or credit, thus consenting by course of performance to the inclusion of the additional remedy terms in the contract between them.

The court's position seems sound. Most courts agree that materially altering additional terms do not become part of the contract merely because the affected party silently proceeds with performance under the contract. Moreover, in *Maxon v. Tyler Pipe Industries*,[17] the Indiana Court of Appeals ruled that the fact an additional term appeared regularly in prior invoices over a long series of

---

13. *See Wilson*, 654 N.E.2d at 856 (Kirsch, J., concurring in part and dissenting in part).

14. 91 F.3d 1002 (7th Cir. 1996).

15. There was some dispute as to whether buyer ever received seller's acknowledgment forms. *See id.* at 1007.

16. *Id.* at 1009. This statement is substantially similar to the observation of the Indiana Court of Appeals in *Wilson* that a "material alteration" is a term that would result in undue surprise or hardship to the recipient who had not read it. *Wilson*, 654 N.E.2d at 850 (citing Maxon Corp. v. Tyler Pipe Indus., Inc., 497 N.E.2d 570, 576 (Ind. Ct. App. 1986)).

17. 497 N.E.2d 570 (Ind. Ct. App. 1986).

transactions and buyer never objected to it did not mean that the term became part of the contract without at least being called to that party's attention. In *Waukesha Foundry*, however, the affected party—the buyer—actually followed the procedures set forth in the additional terms without a murmur of objection during an ongoing relationship that lasted more than four years. Although the term excluding consequential damages initially might have ambushed the buyer by causing unfair surprise or hardship, buyer's regular adherence to the limited remedy provisions demonstrated knowledge of and agreement to the exclusion of consequentials.

Buyer also contended that the limited remedy failed of its essential purpose under U.C.C. section 2-719(2),[18] thereby opening the door to all available Code remedies, including recovery of consequential damages. The Seventh Circuit rejected this argument, finding that the remedy had operated precisely as it was designed to: seller fulfilled its obligation to replace defective castings or to give appropriate credit. Mere delivery of defective goods does not trigger section 2-719(2). If it did, every non-conforming delivery would subject the seller to all remedies under the Code, notwithstanding an agreed limitation of remedies. The complaining party must show that it suffered harm which the limited remedy was incapable of curing. Buyer in *Waukesha Foundry* failed to make this showing.[19]

C. Shrinkwrap Licenses, Offer, Acceptance, and More Section 2-207

A "shrinkwrap license" is a contractual term that "gets its name from the fact that retail [computer] software packages are covered in plastic or cellophane 'shrinkwrap,' and some vendors . . . have written licenses that become effective as soon as the customer tears the wrapping from the package."[20] Other vendors require the user to indicate acceptance of the license's terms by opening an envelope inside the package, by use of the software itself, by clicking the mouse arrow on a "yes" box, or by some other method.[21]

---

18. "Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act." U.C.C. § 2-719(2) (1977).

19. *Waukesha Foundry*, 91 F.3d at 1010.

20. ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1449 (7th Cir. 1996).

21. *See* Stephen J. Davidson & Michael J. Wurzer, *Shrink-Wrap Licenses: The Continuing Controversy* 673 (PLI/Pat., Copyrights, Tradeworks, and Lit. Prop. Practice Course Handbook Series No. 453, 1996); David L. Hayes, *Shrinkwrap License Agreements: New Light on a Vexing Problem*, 15 HASTINGS COMM. & ENT. L.J. 653, 654 (1993).

Similarly, when acquiring, downloading, and installing software electronically over the Internet, the user may be required to review a license agreement and indicate her acceptance of the agreement's terms before using the software. The software may even be programmed to require affirmative indication of agreement before it can be used. *See* Carey R. Ramos & Joseph P. Verdon, *Shrinking and Click-On Licenses After* ProCD v. Zeidenberg, COMPUTER LAW., Sept. 1996, at 1.

The drafters of a new Article 2B to the Uniform Commercial Code, discussed *infra* at notes 34-42 and accompanying text, refer to such licenses as "mass market" licenses.

In the first decision to consider the validity of shrinkwrap licenses in retail sales of computer software, *ProCD, Inc. v. Zeidenberg*,[22] the Seventh Circuit held that "shrinkwrap licenses are enforceable unless their terms are objectionable on grounds applicable to contracts in general (for example, if they violate a rule of positive law, or if they are unconscionable)."[23] At a cost of more than $10 million, ProCD, Inc. had compiled a computer database consisting of information from more than 3000 telephone directories, which it offered for sale on CD-ROM discs under the tradename SelectPhone™. Information could be retrieved from the discs according to any number of criteria with the aid of a program that ProCD also placed on the discs. Because the information was of considerable value to commercial enterprises, ProCD decided to sell its database to the general public for consumer use at a much lower price than it sold the database to commercial users. The box for every consumer version stated that restrictions on use of the software were set forth in an enclosed license. That license, which restricted the consumer version to personal use, was printed in the user's guide, encoded on the

---

22. ProCD, Inc. v. Zeidenberg, 86 F.3d 1447 (7th Cir. 1996), *rev'g* 908 F. Supp. 640 (W.D. Wis.). *See* Ramos & Verdon, *supra* note 21, at 3.

23. *ProCD, Inc.*, 86 F.3d at 1449. Three prior cases touched on the shrinkwrap issue, but did not deal with it directly. In *Vault Corp. v. Quaid Software, Ltd.*, 847 F.2d 255 (5th Cir. 1988), the Fifth Circuit struck down a Louisiana statute that expressly made shrinkwrap licenses valid as contrary to and thus preempted by federal copyright law. The trial court had found that such contracts were invalid as contracts of adhesion. The Fifth Circuit did not discuss the issue.

Step-Saver Data Systems Inc. v. Wyse Technology, 939 F.2d 91 (3d Cir. 1991), involved telephone orders for software by a reseller who loaded the program on computers it sold to retail buyers. The Third Circuit concluded that the sale was completed when the seller accepted the telephoned orders, which detailed the items to be purchased, the price and the shipping and payment terms, but no other terms, restrictions or limitations. Thus, additional terms contained in the shrinkwrap license, which the reseller-buyer had not discussed on the telephone, did not become part of the contract because they materially altered that contract under U.C.C. section 2-207(2)(b).

Arizona Retail Systems v. Software Link, Inc., 831 F. Supp. 759 (D. Ariz. 1993), was similar to *Step-Saver* in that it involved a telephone sale, but the software seller based its argument on the section 2-209 rules on contract modification rather than on section 2-207. Again, the shrinkwrap license was held inapplicable, this time because there was no express agreement to the modification. *See* Davidson & Wurzer, *supra* note 21; Hayes, *supra* note 21.

The issue of shrinkwrap license validity in sales transactions has generated much comment. In addition to the previously cited articles, see, e.g., David A. Einhorn, *Boxtop Licenses and the Battle-of-the-Forms*, 5 SOFTWARE L.J. 401 (1992); Mark A. Lemley, *Intellectual Property and Shrinkwrap Licenses*, 68 S. CAL. L. REV. 1239 (1995); Gary H. Moore & J. David Hadden, *On-Line Software Distribution: New Life for "Shrinkwrap" Licenses*, COMPUTER LAW., Apr. 1996, at 1; Celeste L. Tito, *The Servicewrap: "Shrinkwrap" for Mass-Marketed Software Services*, COMPUTER LAW., May 1996, at 19; D.C. Toedt, III, *Counterpoint: Shrinkwrap License Enforceability Issues*, COMPUTER LAW., Sept. 1996, at 7; Holly Keesling Towle, *Licensing and the Uniform Commercial Code* 147 (PLI/Pat., Copyrights, Tradeworks, and Lit. Prop. Practice Handbook Series No. 454, 1997).

discs, and visible on the screen every time the software was run.[24]

Defendant Zeidenberg bought a consumer version of the SelectPhone™ database. He then formed the co-defendant corporation, and that corporation placed the database on an Internet web page and sold the information at a price substantially lower than that charged by ProCD. ProCD brought an action to enjoin defendants from distributing SelectPhone™ information on the Internet, alleging both copyright infringement and breach of the license agreement.

On cross-motions for summary judgment, the trial court ruled that defendants had neither infringed ProCD's copyright nor assented to the license agreement and the restrictions it contained. With respect to the contract issues, which are the subject of this discussion, the trial court held that (1) the transaction was a sale of goods governed by U.C.C. Article 2; (2) pursuant to U.C.C. sections 2-204 and 2-206,[25] defendant's payment for the software constituted an acceptance of the

---

24. As described by the trial court,

The user guide includes a series of terms entitled, "Single User License Agreement." The agreement states in its opening paragraph:

> Please read this license carefully before using the software or accessing the listings contained on the discs. By using the discs and the listings licensed to you, you agree to be bound by the terms of this License. If you do not agree to the terms of this License, promptly return all copies of the software, listings that may have been exported, the discs and the User Guide to the place where you obtained it.
>
> . . . .

Before a user can access the listings a field appears on the computer screen, stating:

> The listings contained within this product are subject to a License Agreement. Please refer to the Help menu or to the User Guide.

In addition, most screens contain the following warning:

> The listings on this product are licensed for authorized users only.

The user agreement provides that copying of the software and the data may be done only for individual or personal use and that distribution, sublicense or lease of the software or the data is prohibited. The agreement provides expressly that:

> [Y]ou will not make the Software or the Listings in whole or in part available to any other user in any networked or time-shared environment, or transfer the Listings in whole or in part to any computer other than the computer used to access the Listings.

The SelectPhone™ box mentions the agreement in one place in small print. The box does not detail the specific terms of the license.

ProCD, Inc. v. Zeidenberg, 908 F. Supp 640, 644-45 (W.D. Wis.), *rev'd*, 86 F.3d 1447 (7th Cir. 1996).

25. Section 2-204(1) states, "A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of

software retailer's offer to sell, which had been made by placing the software on the shelf; and (3) whether considered under section 2-207 or section 2-209,[26] the license agreement restrictions were nothing more than proposals for addition to or modification of the contract about which the defendant buyer did not know at the time of acceptance of payment, to which he did not agree, and which therefore did not bind him. As to the reference to the restrictions on the package, the trial court stated, "Mere reference to the terms at the time of the initial contract formation does not present buyers an adequate opportunity to decide whether they are acceptable. They must be able to read and consider the terms in their entirety."[27]

The Seventh Circuit agreed with the district court that, notwithstanding the characterization as a license, the transaction was a sale of goods governed by the UCC.[28] The court also agreed that a buyer cannot be bound by hidden terms. Contrary to the district court, however, the Seventh Circuit ruled that defendant did agree to be bound by the license's terms. The court rejected the position that the entire agreement must appear on the box, stating

> Vendors can put the entire terms of a contract on the outside of a box only by using microscopic type, removing other information that buyers might find more useful (such as what the software does, and on which computers it works), or both. The "Read Me" file included with most software, describing system requirements and potential incompatibilities,

---

such a contract." U.C.C. § 2-204(1) (1995).

Section 2-206(1)(a) states, "Unless otherwise unambiguously indicated by the language or circumstances[,] an offer shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances." *Id.* § 2-206(1)(a).

26. Section 2-209(1) states, "An agreement modifying a contract within this Article needs no consideration to be binding." *Id.* § 2-209(1).

27. *ProCD*, 908 F. Supp. at 654. The district court's conclusion has been sharply criticized:

> The district court's ruling in *ProCD* demonstrates how far judicial interpretation of EULAS [End User License Agreements—i.e., shrinkwrap licenses] departs from commercial reality in software transactions. The end user in *ProCD* was notified four separate times (on the product package, in the user guide, upon installation of the software, and prior to gaining access to the product's data) that the use of the software was subject to the EULA . . . .

Robert W. Gomuliewicz & Mary L. Williamson, *A Brief Defense of Mass Market Software License Agreements*, 22 RUTGERS COMPUTER & TECH. L.J. 335, 338 n.4 (1996).

28. *ProCD*, 86 F.3d at 1450. The only Indiana appellate case dealing with a sale of computer software is *Data Processing Services, Inc. v. L. H. Smith Oil Corp.*, 492 N.E.2d 314 (Ind. Ct. App. 1986), in which the court held that the development and sale of software containing an accounting system specially prepared to meet the buyer's needs and unaccompanied by a sale of hardware was more analogous to a sale of legal or accounting advice than to a sale of goods and, therefore, was not governed by the UCC *Id.* at 318. The court noted that the tangible floppy discs may have been incidentally involved, but it was the skill and knowledge of the programmer that was the essence of the transaction. *Id.* Language in the case, however, seems to indicate that a mass-marketed computer program already on discs would be a sale of goods. *Id.* at 318-19.

> may be equivalent to ten pages of type; warranties and license restrictions take still more space. Notice on the outside, terms on the inside, and a right to return the software for a refund if the terms are unacceptable (a right that the license expressly extends), may be a means of doing business valuable to buyers and sellers alike.[29]

The Seventh Circuit also rejected the district court's conclusion that a contract was formed when defendant, in response to the offer of sale made by placing the package on the shelf, accepted the offer and formed the contract "simply by paying the price and walking out of the store."[30] Rather, ProCD, as master of its offer to sell, "proposed a contract that a buyer would accept by using the software after having an opportunity to read the license at leisure. . . . He had no choice, because the software splashed the license on the screen and would not let him proceed without indicating acceptance [of its terms]."[31]

The Seventh Circuit's result appears to be both economically sound and legally correct. Apparently, at the time defendant purchased the software, he was aware that he was buying the consumer version, not the commercial version, and should have realized that there were greater differences than merely price between the two versions. Thus, even if the trial court were correct that the contract was formed when Zeidenberg paid for the software and left the store, Zeidenberg knew (or should have known) that there were restrictions of some kind on the use of the software. His reasonable expectation was that the contract of sale was for a product for consumer use. Moreover, in this rapidly expanding computer age, even the minimally computer literate know that computer software usually contains various terms, conditions, and instructions in the program itself to which the user must express assent in some fashion before the software can be used. In fact, after Zeidenberg's first purchase, he purchased two updated versions of SelectPhone™, so he obviously knew that there was a license agreement inside.[32]

---

29. *ProCD*, 86 F.3d at 1451.

30. *Id.* at 1452.

31. *Id.* (citing U.C.C. § 2-204(1) (1995)) ("A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract.").

Commenting on *ProCD*, the court in *Micro Star v. Formgen, Inc.*, 942 F. Supp. 1312, 1317 (S.D. Cal. 1996), stated,

> [T]here was no question that the movant knew of the license, and knew that by his actions he was consenting to its restrictions. This was so because the box contained a statement that users were bound by the license agreement enclosed, and the license was printed on the CD ROM disc, in the manual, and appeared on the screen every time the program ran.

32. The district court stated that Zeidenberg subsequently purchased two updated versions of SelectPhone™, and may have known the terms of the user agreement at the time of those purchases. The district court noted, however, that a decision on whether Zeidenberg was bound by the agreement at the time of those purchases was "a close call," particularly because the software manufacturer was free to change the agreement between the purchases of various versions. ProCD,

Further, the inclusion of such terms in the user's manual and in the software itself, in the age of computer literacy, may have by now risen to the status of a usage of trade that need not be expressed at all at the time when the contract is formed, yet is a part of the contract.[33]

A further comment on the future of shrinkwrap licenses is in order. The sponsors of the UCC, the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) currently are engaged in a major revision of Article 2. As an offshoot of that project, a new Article 2B dealing with licensing of intellectual property, including computer software, is being drafted as well. Both the district court and the Seventh Circuit referred to a draft that would validate shrinkwrap or "standard-form user" licenses.[34] The district court suggested that this draft cast doubt on the present validity of such licenses. The Seventh Circuit found this reasoning flawed, stating that "[n]ew words may be designed to fortify the current rule with a more precise text that curtails uncertainty."[35]

New words also may be necessary to deal with circumstances that were not envisioned when the old words were written. The original version of Article 2 was written for a 1950s economy when the software industry, now a major part of the economy, did not exist and was not even envisioned.[36] That the current law does not deal expressly with shrinkwrap licenses does not mean that law cannot be applied in the spirit of the Code's admonition that it "be liberally construed and applied to promote its underlying purposes and policies,"[37] including "moderniz[ation] of the law governing commercial transactions" and permit[ting] the continued expansion of commercial practices through custom, usage and agreement of the parties."[38]

In dealing with shrinkwrap licenses, the drafters of Article 2B have created the idea of a "mass-market license," one which typically involves a contract "in the nature of a standard form used in multiple transactions without any opportunity for bargaining."[39] Section 2B-308(a) provides that "a party adopts the terms of mass-

---

Inc. v. Zeidenberg, 908 F. Supp. 640, 654 (W.D. Wis.), *rev'd*, 86 F.3d 1447 (7th Cir. 1996).

33. *See* U.C.C. § 1-205(2) (1995) ("A usage of trade is any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question.").

34. *See ProCD*, 86 F.3d at 1452; *ProCD*, 908 F. Supp. at 655. The courts referred to section 2-2203 but neither opinion indicated the date of the draft to which they were referring. There have been several drafts since the date of the trial court opinion, and the sections have been renumbered.

35. *ProCD*, 86 F.3d at 1452.

36. *See* Preface to Article 2B Licenses (Draft Dec. 12, 1996), pt. 1, at 4-5 (discussing Modern Economy and Law Reform). Drafts of Article 2B are available through the Internet on the Uniform Commercial Code Article 2B Revision Home Page. <http://www.lawlib.uh.edu:80/ucc2b> (visited July 30, 1997).

37. U.C.C. § 1-102(1) (1995).

38. *Id.* § 1-102(2)(a), (b).

39. Preface to Article 2B Licenses (Draft Dec. 12, 1996), pt. 1, at 23-24 (discussing Mass

market license if the party agrees, including by manifesting assent, to the mass-market license before or in connection with the initial performance or use of or access to the information."[40] Section 2B-112 provides that a party manifests assent if, after an opportunity to review the terms, she engages in conduct "that the record [software] conspicuously provides or the circumstances, including the terms of the record, clearly indicate constitute acceptance" of the terms, and has an opportunity to decline the terms, but mere retention without objection is not assent.[41] The Reporter's Notes to this section state that "an affirmative act of clicking on a displayed button [with a mouse] in response to an on screen description that this act constitutes acceptance of a particular term or an entire contract" would be effective.[42] Applying these proposed provisions to *ProCD* would yield the same result as that reached by the Seventh Circuit without the necessity of determining whether the contract was formed at the cashier's desk in the software store or after the buyer reviewed the user's manual and the computer screens and clicked his intention to use the software.

One comment about section 2-207 in the Seventh Circuit's opinion causes some concern. The court stated, "Our case has only one form; UCC § 2-207 is irrelevant."[43] Although section 2-207 may often involve a battle of two forms in an offer-acceptance context where the response to the offer differs in some respect, section 2-207 clearly is applicable as well when an oral agreement involving words and conduct, but no forms, is followed by a single written confirmation by one of the parties. The only thing that saves the court's analysis in this instance is its conclusion that there was not yet a contract until defendant Zeidenberg assented to the license agreement in the manner set forth therein. Once he knew of the license agreement and its limitations, in the court's analysis, his use of the software was an expression of acceptance of all of the terms.

Market Definition and Use). "Mass-market license" is defined in section 2B-102(28) as "a standard form that is prepared for and used in a mass-market transaction." U.C.C. § 2B-102(28) (NCCUSL Annual Meeting Draft July 25-Aug. 1, 1997). "Mass-market transaction" is defined as "a transaction in a retail market for information involving information directed to the general public as a whole under substantially the same terms for the same information, and involving an end-user licensee that acquired the information in a transaction under terms and in a quantity consistent with an ordinary transaction in the general retail distribution." *Id.* § 2B-102(29). Certain transactions are expressly excluded: (1) nonconsumer transactions involving more than an as yet to be established amount; (2) transactions involving information specially prepared for the licensee; (3) licenses of the right to publicly perform or display a copyrighted work; and (4) commercial site licenses and access contracts between businesses. *Id.* § 2B-102(29)(A)-(D).

40. *Id.* § 2B-308(a).

41. *Id.* § 2B-112(a), (b).

42. *Id.* § 2B-112 reporter's note 3. It should be noted that "there have been strong objections voiced to these provisions, and it remains to be seen if this standard industry practice is validated in Article 2B." Terrence P. Maher & Margaret L. Milroy, *Licensing in a New Age—Contracts, Computers and the UCC*, BUS. L. TODAY, Sept./Oct. 1996, at 22, 26.

43. ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1452 (7th Cir. 1996), *rev'g* 908 F. Supp. 640 (W.D. Wis.).

D. Telephone Orders and Section 2-207

In *Hill v. Gateway 2000, Inc.*,[44] the Seventh Circuit applied the reasoning of *ProCD* to a case involving the purchase of a computer by telephone. The buyers, in response to a computer magazine advertisement that described the components and technical characteristics of a specific computer system manufactured by the seller,[45] ordered a computer over the telephone and gave a credit card number by way of payment.[46] The box that arrived contained the computer, "a 'Standard Terms and Conditions Agreement,' and a 'Three Year Limited Warranty,' which had various exclusions and limitations."[47] The Standard Terms and Conditions Agreement included a dispute resolution clause that required submission of all disputes to arbitration and disclaimed liability for consequential damages,[48] as well as a statement that these terms "govern unless the customer returns the computer within 30 days."[49]

Dissatisfied with the components incorporated into the computer system and their performance, the buyers filed a multi-count class action in which they alleged violations of the warranty provisions of the UCC, the Magnusson-Moss Federal Warranty Act, the Racketeer Influenced and Corrupt Organization Act (RICO), and the Illinois and South Dakota Consumer Fraud Acts.[50] When the seller moved to enforce the arbitration clause, the district court refused, stating that "[t]he present record is insufficient to support a finding of a valid arbitration agreement . . . or that the plaintiffs were given adequate notice of the arbitration clause."[51]

The Seventh Circuit relied upon its decision in *ProCD* to find that the arbitration provision was binding upon the buyers. Refusing to limit *ProCD* to the computer software context, the court stated, "Gateway shipped the computers with the same sort of accept-or-return offer ProCD made to users of its software."[52] The court continued:

> Payment preceding the revelation of full terms is common for air transportation, insurance, and many other endeavors. Practical considerations support allowing vendors to enclose the full legal terms with their products. Cashiers cannot be expected to read legal documents

---

44. 105 F.3d 1147 (7th Cir. 1997). A detailed recitation of the facts of this case appears in the district court memorandum opinion and order. *See* Hill v. Gateway 2000, Inc., 1996 WL 650631, No. 96C4806 (N.D. Ill. Nov. 7, 1996).

45. *Hill*, 1996 WL 650631, at *1-2.

46. *Hill*, 105 F.3d at 1148.

47. *Hill*, 1996 WL 650631, at *2.

48. *Id.*

49. *Hill*, 105 F.3d at 1148.

50. *Hill*, 1996 WL 650631, at *1.

51. *Hill*, 105 F.3d at 1148. The opinion of the district court in which it denied the seller's motion to enforce the arbitration clause is not reported, nor is it presently available in any electronic database. The memorandum opinion and order only deal with the motion to certify the class.

52. *Id.*

> to customers before ringing up sales. If the staff at the other end of the phone for direct-sales operations such as Gateway's had to read the four-page statement of terms before taking the buyer's credit card number, the droning voice would anesthetize rather than enlighten many potential buyers. Others would hang up . . . .[53]

As it did in *ProCD*, the court stated that, notwithstanding the buyer's argument, section 2-207 was irrelevant to the transaction. The issue in both cases was

> how and when the contract was formed—in particular, whether a vendor may propose that a contract of sale be formed, not in the store (or over the phone) with the payment of money or a general "send me the product," but after the customer has had a chance to inspect both the item and the terms.[54]

Because the buyers failed to return the computer within thirty days from purchase as required by the Standard Terms and Conditions Agreement included in the computer box, they had accepted the seller's offer under the seller's terms and, therefore, were required to arbitrate.

The Seventh Circuit's approach certainly is innovative. Indiana courts have long adhered to the general rule that modifications of warranties and limitations of remedies not brought to the buyer's attention until after the sale is made (for example, terms included in a booklet in the glove compartment of a new car) are ineffective.[55] In prior times, warranties, disclaimers, limitations and other terms, whether favorable to one party or the other, were either discussed specifically or set forth in the writing signed by both parties before payment and delivery. Section 2-207 was drafted to deal in part with offeree's responses that indicated acceptance but contained terms that changed the terms of the contract that was formed, thereby trapping the offeror into a contract different from that which she expected would control the transaction. In the setting of both *ProCD* and *Hill*, the buyers, at the time of payment and delivery, knew that there were terms as yet unseen. Some of these terms were of benefit to the buyers; some may have limited their rights and remedies. But the reasonable expectation of the buyers was that there were terms yet to be read. As long as an opportunity exists to return the goods for full refund in the absence of willingness to abide by those terms, thereby indicating rejection of the seller's offer, the reasonable expectations are fulfilled.[56]

---

53. *Id.* at 1149.

54. *Id.*

55. *See* Hahn v. Ford Motor Co., 434 N.E.2d 943, 948 (Ind. Ct. App. 1982) (citing cases from other jurisdictions).

56. The *Hill* court touches on the issue of what happens if the return requirement is onerous—for example, if the expense of shipping were unreasonably high. "What the remedy would be in such a case—could it exceed the shipping charges?—is an interesting question, but one that need not detain us because the Hills knew before they ordered the computer that the carton would include some important terms, and they did not seek to discover these in advance." *Hill*, 105

As noted above, NCCUSL and the ALI are presently engaged in a revision of Article 2. One of the problems with which the drafters are struggling relates to standard form contracts such as those involved in both *ProCD* and *Hill*.[57] How the drafters ultimately will deal with the issue remains to be seen.

II. ARTICLES 3 AND 4—NEGOTIABLE INSTRUMENTS AND BANK DEPOSITS AND COLLECTIONS

UCC Articles 3 and 4 were revised by NCCUSL and the ALI in 1990. Indiana adopted revised Articles 3 and 4, effective July 1, 1994.[58] As is the case with the decisions discussed in this Survey, however, the great majority of cases still are being decided under pre-revision Articles 3 and 4 because they involve transactions that took place before the effective date of the revisions.

A. *Definition of "Negotiable Instrument"*

Article 3 only applies to "negotiable instruments."[59] Non-negotiable instruments are governed by common law principles.[60] Under Article 3, an instrument's negotiability is determined by whether the instrument, on its face, meets the formal requirements for negotiability set out in Article 3. Under pre-revision U.C.C. section 3-104, these requirements are that the instrument (1) be signed by the maker or drawer; (2) "contain an unconditional promise or order to pay a sum certain in money and no other promise" except those authorized by Article 3; (3) be payable either on demand or at a definite time; and (4) be payable either to order or to bearer.[61] If the face of the instrument satisfies these requirements, then it is a negotiable instrument; if it does not, then it is non-negotiable.

F.3d at 1149.

57. *Compare* U.C.C. § 2-206 (Nov. 1996 Draft) *with* U.C.C. §§ 2-205, 2-206 and 2-207 (NCCUSL Annual Meeting Draft July 25-Aug. 1, 1997). The earlier draft dealt specifically with the concept of standard form contracts, such as those contained in *ProCD* and *Hill*. The later draft deleted rules dealing with standard forms. In the Reporter's Notes to section 2-205, the Reporter discussed *ProCD* and *Hill*, stated questions raised at a May 1997 meeting of the Drafting Committee as to whether Article 2 adequately supports the decisions, and proposed a solution. However, no final action was taken on the proposal.

58. Act of Apr. 30, 1993, No. 222, §§ 5-45, 1993 Ind. Acts 4222, 4231-4316.

59. U.C.C. § 3-102(a)(1990); U.C.C. § 3-103 cmt. 1 (1989). Citation to the pre-revision Article 3 is indicated by the date 1989. Citation to revised Article 3 is indicated by the date 1990.

60. Pre-revision Article 3 contained one exception to this rule: pre-revision Article 3 applied to a non-negotiable instrument if the only reason the instrument was non-negotiable was that it was not payable to order or bearer and the terms of the instrument did not preclude transfer. U.C.C. § 3-805 (1989). There could not, however, be a holder in due course of such an instrument. *See id.* This provision was deleted in the revision.

61. U.C.C. § 3-104(1)(a)(d) (1989). Revised section 3-104 contains similar requirements. U.C.C. § 3-104(a)(1)-(3) (1990).

In *Yin v. Society National Bank Indiana*,[62] the Indiana Court of Appeals addressed for the first time the question of whether a line of credit was a negotiable instrument governed by Article 3. Plaintiff Society National Bank Indiana had entered an agreement with U.S.A. Diversified Products (USAD) to loan USAD up to $2,000,000 in the form of an operating line of credit. The agreement was evidenced by a note, which was signed by Davis, both as president of USAD and individually, and by defendants Yin and Kung in their individual capacities as accommodation parties.[63] Subsequently, Society agreed to give USAD a sixty day extension of the due date of the note. Davis represented that he would obtain the signatures of Yin and Kung on the extension note, but the parties agreed for purposes of Society's motion for summary judgment that Yin and Kung's signatures on the extension note were forgeries. USAD defaulted on the line of credit and Society brought an action to collect the debt. Yin and Kung asserted defenses to payment based on their accommodation party status. They argued that their obligation had been discharged by the grant of an extension of time to USAD, and by Society's failure to notify them of misconduct by USAD.[64]

Applying the pre-revision Article 3, the trial court held that the line of credit was a negotiable instrument governed by Article 3,[65] and that Yin and Kung therefore were limited to the suretyship defenses contained in pre-revision U.C.C. section 3-606.[66] The trial court granted partial summary judgment in favor of Society against Yin and Kung for $2,160,331.73, including interest, attorney fees and expenses, concluding that the extension (the suretyship defense included in section 3-606)[67] did not discharge their liability on the note.[68]

On appeal, Yin and Kung argued that the trial court had erred in finding that the agreement for a line of credit was a negotiable instrument, and in denying them the benefit of common law suretyship defenses.[69] The Indiana Court of Appeals held that the line of credit was not a negotiable instrument and that, therefore, the applicable law was Indiana common law, including common law suretyship defenses.[70]

The court found that the line of credit failed to meet the formal requisites of

---

62. 665 N.E.2d 58 (Ind. Ct. App. 1996), *trans. denied.*

63. Society admitted for purposes of its motion for summary judgment that Yin and Kung were accommodation parties. *See id.* at 63.

64. Yin and Kung presented evidence that USAD was not abiding by certain terms of the loan agreement and was impairing collateral securing the loan, and that Society had acquiesced in, and perhaps encouraged, USAD's misconduct. *See id.* at 65.

65. *See id.* at 62.

66. *See id.* at 67 (Sharpnack, C.J., concurring).

67. "The holder discharges any party to the instrument to the extent that without such party's consent the holder (a) without express reservation of rights releases or agrees not to sue any person against whom the party has to the knowledge of the holder a right of recourse or agrees to suspend the right to enforce against such person . . . ." U.C.C. § 3-606(1)(a) (1989).

68. *Yin*, 665 N.E.2d at 61, 63.

69. *Id.* at 62, 67.

70. *See id.* at 63.

a negotiable instrument both because it did not contain a "sum certain" and because it did not contain "an unconditional promise or order to pay."[71] The court reasoned that the line of credit was not for a sum certain because USAD was under no obligation to make any draws upon the line of credit, and the draws that it chose to make could be in varying amounts. Thus, "an important feature of the line of credit" was that "in order to ascertain the principal amount owed, one must look beyond the agreement itself" to the history of USAD's draws.[72] Therefore, the court concluded that "[b]ecause of the potentially variable principal which results from such an arrangement, the line of credit contains no sum certain."[73] The court found that the agreement did not contain an unconditional promise to pay because Society had conditioned USAD's ability to make draws under the line of credit upon the sufficiency of USAD's accounts receivable.[74] The court then went on to hold that there were genuine issues of material fact relating to Yin and Kung's common law suretyship defense based on Society's failure to notify them of USAD's misconduct which made the trial court's grant of partial summary judgment inappropriate.[75]

Although the court may have reached the right result in *Yin*, its negotiability analysis is clearly misguided. First, the court's conclusion that the agreement did not contain an unconditional promise to pay because Society's obligation to make advances under the line of credit agreement was not unconditional is simply wrong. It is the *maker's* promise to pay, not the *lender's* promise to make the loan, that must be unconditional.[76] More fundamentally, as Chief Judge Sharpnack stated in his concurrence, the issue is not whether the line of credit constitutes a negotiable instrument, but rather "whether the document in question is a negotiable instrument."[77] The "document in question" was a promissory note, which stated:

> On April 30, 1992, for value received, the undersigned ("Borrower") promises to pay to the order of SOCIETY BANK, INDIANA ("BANK") at its principal office in South Bend, Indiana: Two Million and 00/100 DOLLARS with interest from date hereof to maturity or until paid in full. . . .[78]

A cardinal principle of negotiable instruments law is that the negotiability of an

---

71. *Id.* at 62 (quoting U.C.C. § 3-104(1) (1989)).

72. *Id.* at 63.

73. *Id.*

74. *See id.* The court stated, "Society conditioned USAD's access to the line of credit by tracking the company's collateral. Lacking an unconditional promise to pay a sum certain, the line of credit falls outside the definition of a negotiable instrument." *Id.*

75. *See id.* at 65.

76. *See* U.C.C. § 3-104(1)(b) (1989) (in order to be a negotiable instrument, writing must "contain an unconditional promise . . . to pay . . . and no other promise . . . given by the maker . . . .").

77. *Yin*, 665 N.E.2d at 66 (Sharpnack, C.J., concurring).

78. *Id.*

instrument must be determined from the face of the instrument.[79] This rule facilitates the free transferability of negotiable instruments by allowing the transferee "to trust what the instrument says, and be able to determine the validity of the note and its negotiability from the language of the note itself."[80] This so-called "four corners rule" is crucial to the concept of holder in due course, as it means that "transferees in the ordinary course of business are only to be held liable for information appearing in the instrument itself and will not be expected to know of any limitations on negotiability or changes in terms, etc., contained in any separate documents."[81] Although the court of appeals mentions this rule in passing,[82] it does not seem to have applied the rule in reaching its decision. As the concurring opinion states, the terms of the promissory note before the court show "a clear unconditional promise to pay two million dollars."[83]

The note did contain a notation in its right margin under the heading "disbursement" which stated "Draws to C/A #946009-372." The concurring opinion suggests that the court relies on this language in concluding that the instrument does not contain an unconditional promise to pay a sum certain.[84] This "draws" language rationale for the court's conclusion does have the advantage of placing the court's analysis within the four corners rule. Even if this language is the true basis of the majority's decision, however, the decision is still misguided.[85]

---

79. *See, e.g.* U.C.C. § 3-105, Official Comment, Purposes of Changes (1989) ("This section is intended to make it clear that, so far as negotiability is affected, the conditional or unconditional character of the promise or order is to be determined by what is expressed in the instrument itself. . . .").

80. First State Bank v. Clark, 570 P.2d 1144, 1147 (N.M. 1977), *quoted in Yin*, 665 N.E.2d at 66 (Sharpnack, C.J., concurring).

81. *Id. See also* ROBERT L. JORDAN & WILLIAM D. WARREN, COMMERCIAL PAPER 669-670 (4th ed. 1997):

> Merger theory and the ability of a good faith purchaser for value to take free of claims and defenses with respect to the instrument were based on a separation of the right to payment represented by the instrument from the transaction giving rise to the instrument. But merger theory assumed that the terms of the instrument were not inconsistent with separation from the underlying transaction, and that the terms of the right to receive payment could be determined simply by examination of the instrument itself. Thus the consequences of negotiability were applied by the common law courts only if the instrument met certain criteria that satisfied these assumptions.

82. *See Yin*, 665 N.E.2d at 62 ("note did not facially demand payment of a sum certain").

83. *Id.* at 66 (Sharpnack, C.J., concurring).

84. *Id.* at 67.

85. The majority opinion mentions this language only in passing by stating, "The parties do not seriously dispute that the agreement in the present case is a line of credit upon which USAD could make draws of varying amounts. Indeed, the face of the note contains a notation regarding 'draws.'" *Id.* at 62-63. The failure to focus on this language as important to its analysis is typical of the majority's analysis, which is focused on the nature of the deal between the parties, not the terms of the instrument that was signed. Indeed, the majority opinion does not even mention what the note actually said.

As the concurring opinion notes, "[t]he 'draws' reference does not tell us anything, let alone that the parties may have issued this note in conjunction with a line of credit."[86] More importantly, even if one could glean a reference to the line of credit from this language, such a reference in the note would not of itself destroy the note's negotiability. Pre-revision U.C.C. section 3-105 states that a promise "is not made conditional by the fact that the instrument . . . states . . . the transaction which gave rise to the instrument, or that the promise . . . is made or the instrument matures in accordance with or "as per" such transaction."[87]

Chief Judge Sharpnack's concurring opinion clearly contains the better analysis of the negotiability issue. Under the four corners rule of Article 3, the fact that the parties' actual agreement may have placed conditions on payment or provided for different payment terms from those stated in the instrument is simply irrelevant to the negotiability determination as long as the terms of the instrument itself state an unconditional promise to pay a sum certain.[88] Thus, the majority's focus in its analysis on the nature of the underlying transaction between the parties that gave rise to the instrument rather than on the language of the instrument itself was error.

B. Exclusivity of Article 3 Accommodation Party Defenses

Yin also raises the issue of whether the special defenses provided to accommodation parties under Article 3 are exclusive, precluding the assertion of suretyship defenses otherwise available to the accommodation party under the common law.[89] This issue was an important one in *Yin* because defendants' best argument with regard to the existence of genuine issues of material fact precluding summary judgment related to the common law suretyship defense of discharge due to Society's failure to notify them of USAD's misconduct.[90] The majority opinion

---

86. *Id.* at 67 (Sharpnack, C.J., concurring).

87. U.C.C. § 3-105(1)(b) (1989). *Cf.* U.C.C. § 3-106(a) (1990) ("A reference to another writing does not of itself make the promise or order conditional.")

88. *See* U.C.C. § 3-119 (1989) (Terms of an instrument may be modified or affected by any other written agreement executed as part of the same transaction, but "[a] separate agreement does not affect the negotiability of an instrument.").

89. Pre-revision U.C.C. section 3-415 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." U.C.C. § 3-415(1) (1989). *Cf.* U.C.C. § 3-419(a) (1990) (accommodation party is a party to the instrument who "signs the instrument for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument"). An accommodation party is a type of surety. *See* Farmers Loan & Trust Co. v. Letsinger, 635 N.E.2d 194, 197 (Ind. Ct. App. 1994), *aff'd and adopted in part*, 652 N.E.2d 63 (Ind. 1995).

90.

> Where, during the existence of the suretyship relation, the creditor discovers facts unknown to the surety which would give the surety the privilege of terminating his obligation to the creditor as to liability for subsequent defaults, and the creditor has reason to believe these facts are unknown to the surety and has a reasonable opportunity

in *Yin* did not reach the exclusivity issue because of the court's determination that there was no negotiable instrument involved and, therefore, that the only defenses applicable were those available at common law. Because Chief Judge Sharpnack would have found that a negotiable instrument was involved, he did reach this issue in his concurrence, concluding that the suretyship defenses found in pre-revision U.C.C. section 3-606 did not preclude resort to other suretyship defenses available at common law.[91]

Chief Judge Sharpnack's conclusion seems correct. U.C.C. section 1-103 provides that "[u]nless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions."[92] Not only does section 3-606 not contain any express language excluding other suretyship defenses,[93] but there is no indication that the purpose or policy of section 3-606 would be disserved by allowing accommodation parties to assert suretyship defenses other than those expressly contained in that section. An accommodation party "differs from other sureties only in that his liability is on the instrument and he is a surety for another party to it."[94] The Article 3 provisions dealing with accommodation parties are designed primarily to deal with aspects of accommodation party status that are influenced by the fact an accommodation party is also a party to a negotiable instrument, not to provide a comprehensive set of rules governing all aspects of suretyship status. As the Permanent Editorial Board of the Uniform Commercial Code stated in a recent PEB Commentary, the Article 3 sections dealing with accommodation parties "will not resolve all possible issues concerning the rights and duties of the surety," and when "a situation is presented that is not resolved by those sections, the resolution may be provided by the general law of suretyship because, pursuant to § 1-103, that law is applicable unless displaced by provisions of [the Code]."[95]

> to communicate them to the surety without a violation of the confidential duty, the creditor has a duty to notify the surety, and breach of this duty is a defense to the surety except in respect of his liability for defaults which have occurred before such disclosure should have been made.

RESTATEMENT OF SECURITY § 124(2) (1941). *See also* Indiana Telco Fed. Credit Union v. Young, 297 N.E.2d 434, 435 (Ind. App. 1973). Yin and Kung argued, and the court of appeals found, that there were genuine issues of material fact as to whether Society discovered facts unknown to Yin and Kung that would have given them the option to terminate their obligation to Society, whether Society had reason to believe Yin and Kung were unaware of these facts, and whether Society had a reasonable opportunity to communicate these facts to Yin and Kung. *Yin*, 665 N.E.2d at 65.

91. *Yin*, 665 N.E.2d at 68 (Sharpnack, C.J., concurring).

92. U.C.C. § 1-103 (1995).

93. Judge Sharpnack stated that "applying the mandate of [section 1-103], the common law defenses may not be excluded absent an express provision in [section 3-606]." *Yin*, 665 N.E.2d at 68 (Sharpnack, C.J., concurring).

94. U.C.C. § 3-415 cmt. 1 (1989).

95. PEB Commentary No. 11, Suretyship Issues Under Sections 3-116, 3-305, 3-415, 3-419, and 3-605 (1994). Although the PEB Commentary discusses the pre-revision provisions dealing with accommodation parties, its primary focus is on the relationship between the accommodation

C. Depositary Banks as Holders in Due Course

Normally, when a customer deposits a check in her account, the depositary bank merely acts as the customer's agent in collecting the check.[96] The depositary bank gives the customer a provisional credit in the amount of the check and forwards the check through the bank collection process for presentment to the payor bank. If the check is paid, the provisional credit becomes final;[97] if the check is dishonored, the depositary bank revokes the provisional credit, debiting the customer's account for the amount of the unpaid check.[98] The dishonored check is returned to the customer, who then has the task of attempting to collect from the drawer of the check. The depositary bank, however, becomes the holder of a check deposited with it by its customer,[99] and, if it meets the requirements of section 3-302, it can be a holder in due course.[100] As holder of the check, the depositary bank has the option of attempting to collect the check from the drawer rather than debiting its customer's account.

Braden Corp. v. Citizens National Bank[101] involved an attempt by Citizens National Bank, as depositary bank with regard to a $5000 dishonored check, to collect the amount of the dishonored check from Braden Corp., the corporation on whose account the check was drawn, and Braden's president, Frank W. Splittorff, who had signed the corporate check. The check was made payable to Polymer Technology Corp., an unrelated corporation of which Splittorff also was president.

---

party provisions of revised Article 3 and the common law of suretyship, particularly as stated in the Restatement of the Law (Third), Suretyship & Guaranty (1996). Revised Article 3 contains a more comprehensive treatment of accommodation party issues than the original Article 3, including suretyship defenses. *Compare* U.C.C. § 3-606 (1989) *with* U.C.C. § 3-605 (1990). Nevertheless, as the PEB Commentary illustrates, like the pre-revision Article 3, revised Article 3 was enacted against the backdrop of general suretyship law and relies upon the general law of suretyship to provide the applicable rules in the numerous areas not explicitly addressed by the Article 3 provisions.

96. *See* U.C.C. § 4-201(1) (1989) ("Unless a contrary intent clearly appears and prior to the time that a settlement given by a collecting bank for an item is or becomes final, . . . the bank is an agent . . . of the owner of the item and any settlement given for the item is provisional."); U.C.C. § 4-201(a) (1990) (same rule).

97. *See* U.C.C. § 4-213(3) (1989); U.C.C. § 4-215(d) (1990).

98. *See* U.C.C. § 4-212(1) (1989); U.C.C. § 4-214(a)(1990).

99. Under pre-revision Articles 3 and 4 this was true at least in the vast majority of cases in which the customer indorsed the check before deposit. Revised section 4-205 provides that the depositary bank becomes the holder of checks deposited with it by its customers for collection whether or not the customer indorses the check. U.C.C. § 4-205(1) (1990).

100. Pre-revision U.C.C. section 3-302 provides that, in order to be a holder in due course, the holder must take the instrument (1) for value, (2) in good faith, and (3) "without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person." U.C.C. § 3-302(1)(a)-(c) (1989).

101. 661 N.E.2d 838 (Ind. Ct. App. 1996).

Polymer deposited the check in its account with Citizens, and the $5000 provisional credit given for the check was immediately applied to cover checks that Polymer had drawn on the account. Despite four presentments of the check to the payor bank for payment, the last made in person by an employee of Citizens, the check was never paid, and Citizens brought an action to collect the amount of the check, as well as for fraud and check deception, against Braden and Splittorff. The trial court granted summary judgment in favor of Citizens against both defendants. On appeal, Braden and Splittorff challenged the trial court's conclusion that Citizens was a holder in due course and thus not subject to defenses of bankruptcy, failure of consideration and waiver, and its holding that Splittorff was personally liable as drawer of the corporate check.

Applying pre-revision Articles 3 and 4, the Indiana Court of Appeals correctly rejected defendants' argument that Citizens was not a holder in due course because it had not given value for the check. Under pre-revision sections 4-208 and 4-209, a bank gives value with regard to a check deposited in an account "when credit given for the item has been withdrawn or applied."[102] Citizens thus gave value for the check when it applied the provisional credit given for the check to cover checks Polymer had drawn on its account.

The court of appeals also seems correct in rejecting defendants' further argument that Citizens was not a holder in due course because it had a duty to debit Polymer's account when the check was first dishonored, rather than re-presenting the check for payment, and its failure to do so constituted a failure to mitigate damages that barred any recovery. Pre-revision U.C.C. section 4-212 states that the bank "may revoke" the settlement given its customer and charge back the customer's account, not that it "must" do so, and that "failure to charge back or claim refund does not affect other rights of the bank against the customer or any other party."[103] Like any other holder of a negotiable instrument, the depositary bank may choose among the options available to it for collecting on the instrument.[104]

The court of appeals' further determination that because Citizens was a holder in due course it took free of defendants' defenses is, however, somewhat muddled because the court cites to the wrong subsection of section 3-305 to support its

---

102. U.C.C. § 4-208(1)(a) (1989); *accord* U.C.C. § 4-210(a)(1) (1990).

103. U.C.C. § 4-212(1), (5) (1989); *accord* U.C.C. § 4-214(a), (e) (1990).

104. As a practical matter, of course, the depositary bank is not like any other holder for the very reason that it is the depositary bank and, therefore, has a ready source for shifting loss from nonpayment in the form of its customer's account, as long as that account contains sufficient funds to charge back against. The fact that the depositary bank's charge-back remedy is more convenient than any of the remedies available to nonbank holders, however, has never been found persuasive by the drafters as a reason for providing different rules for banks in this regard. In fact, the general tenor of Article 4 has been to provide banks maximum flexibility in choosing how they will deal with items in the collection process. *See, e.g.*, U.C.C. § 4-107 (1989) (allowing bank to set cutoff hour for deposits); *id.* § 4-103 (allowing variation of Code provisions by agreement). At any rate, re-presentment, at least once, is an eminently reasonable option; most dishonored checks are paid upon re-presentment.

conclusion. The court states that Citizens is not subject to defendants' defenses of bankruptcy, failure of consideration or waiver because under section 3-305(1) "a holder in due course takes the instrument free from all claims to it on the part of any person."[105] Although it is indeed true that a holder in due course takes free of all claims, Braden and Splittorff were not asserting a claim to the instrument. They were asserting defenses to payment.[106] The distinction between claims and defenses is not a mere technicality; it is crucial to the determination of whether the holder in due course is protected from the assertions being made. Although a holder in due course takes free of all claims, a holder in due course does *not* take free of all defenses, and one of the defenses to which a holder in due course is subject is "discharge in insolvency proceedings."[107] The opinion does not discuss the nature of the "bankruptcy" defense that defendants asserted; if it were an assertion of discharge in bankruptcy, then Citizens' holder in due course status would not protect the bank under pre-revision section 3-305(2)(d).

D. Personal Liability of Authorized Representative

The *Braden* court also upheld the trial court's determination that Splittorff was personally liable on the check.[108] Splittorff argued that he had signed the check in his capacity as president of Braden Corp., not individually. Splittorff, however, had failed to indicate his corporate capacity by placing "president" after his name when he signed the corporate check as drawer. Pre-revision section 3-403 provides that, except as between the immediate parties to the transaction, an authorized representative is personally obligated on a negotiable instrument "if the instrument names the person represented but does not show that the representative signed in a representative capacity."[109] Splittorff's signature seems to fall within the language of this rule.

Nevertheless, some courts applying pre-revision section 3-403 have refused to find personal liability when, as in *Braden*, the instrument involved was a check of the represented entity that clearly showed the name of the represented entity and the fact that the check was drawn on that entity's account.[110] The rationale for these decisions is, in effect, that when the instrument signed is a check payable from the account of the represented entity, that fact itself means that the instrument shows that the representative signed in a representative capacity. Indeed, if the person signing were not signing in her representative capacity, then it seems there

---

105. *Braden*, 661 N.E.2d at 841 (citing U.C.C. § 3-305(1) (1989)).

106. A claim is an assertion of a superior property or possessory right to the instrument. A defense is an assertion of a reason why a person obligated to pay on the instrument can avoid that obligation.

107. U.C.C. § 3-305(2)(d) (1989).

108. *Braden*, 661 N.E.2d at 841.

109. U.C.C. § 3-403(2)(b) (1989).

110. *See* John S. Herbrand, Annotation, *Construction and Application of UCC § 3-403(2) Dealing with Personal Liability of Authorized Representative Who Signs Negotiable Instrument in His Own Name*, 97 A.L.R.3D 798 (1980).

would be no authorization for the payor bank to debit the represented entity's account, and no basis for finding the represented entity liable as drawer of the check.[111] Finding that an authorized representative is not personally liable under these circumstances seems the better result, and, as the court of appeals recognizes,[112] it is the result that would be reached under revised U.C.C. section 3-402(c).[113] As the comment to revised section 3-402(c) states, "Virtually all checks used today are in personalized form which identify the person on whose account the check is drawn. In this case, nobody is deceived into thinking that the person signing the check is meant to be liable."[114]

III. NEW ARTICLE 5—LETTERS OF CREDIT

As of July 1, 1996, Article 5 of Indiana's Uniform Commercial Code, dealing with letters of credit, was replaced by a new Article 5.1, with conforming amendments to other Articles.[115] Indiana's adoption of Revised Article 5, which was approved by NCCUSL and the ALI in 1995, makes Indiana a leader with respect to updating the Code.

Promulgated in the 1950s as part of the original Code project, the original Article 5 did not envision the tremendous growth in the use of letters of credit and the development of practices and technology unknown at that time.[116] Indeed, original Article 5 had been criticized as containing "significant barriers" to the use

---

111. It therefore seems somewhat illogical to hold an authorized representative in Splittorff's situation personally liable on the check, based on a theory that the representative will not be allowed to establish that he signed in a representative capacity, while at the same time holding the represented entity liable on the check as well, a result that would seem to require that the signature on the check in fact be that of the represented entity. In general, however, courts, including the *Braden* court, have not found this result particularly problematic.

112. *Braden*, 661 N.E.2d at 841 n.3.

113.

> If a representative signs the name of the representative as drawer of a check without indication of the representative status and the check is payable from an account of the represented person who is identified on the check, the signer is not liable on the check if the signature is an authorized signature of the represented person.

U.C.C. § 3-402(c) (1990).

114. U.C.C. § 3-402 cmt. 3 (1990). The court of appeals also affirmed the trial court's award of treble damages pursuant to the Indiana Code section 34-4-30-1 with regard to the check deception claim. *Braden*, 661 N.E.2d at 842. For a discussion of the application of that statute to check deception cases, see Gerald L. Bepko, *Commercial Law*, 15 IND. L. REV. 109, 109-112 (1982).

115. IND. CODE §§ 26-1-5.1-101 to -117 (Supp. 1996).

116. *See* Prefatory Note, Revised Article 5, *in* 2B UNIFORM LAWS ANNOTATED 112, 112 (West Supp. 1997). *See generally* Symposium, *An Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. LAW. 1521 (1990) (comprehensive analysis by the A.B.A. Task Forces on the Study of UCC Article 5).

of electronic technology.[117] As stated by the drafters, the goals in drafting new Article 5 were:

> conforming the Article 5 rules to current customs and practices; accommodating new forms of Letters of Credit, changes in customs and practices, and evolving technology, particularly the use of electronic media; maintaining Letters of Credit as an inexpensive and efficient instrument facilitating trade; and resolving conflicts among reported decisions.[118]

A comprehensive analysis of the changes brought about by the revision would be far more detailed than possible in this Survey. Those attorneys who deal with letters of credit, whether on a regular basis or only occasionally, would be well advised to review carefully the new legislation, the extensive Official Comments prepared by the drafters, and related scholarly works.[119]

IV. ARTICLE 9—SECURED TRANSACTIONS

A. *Proceeds Paid to Third Parties in Ordinary Course*

U.C.C. section 9-306(2) provides that upon a disposition of collateral a security interest "continues in any identifiable proceeds" of the collateral.[120] The security interest in identifiable proceeds need not be expressly granted in the security agreement,[121] and exists even though the interest in the original collateral has been cut off by the transfer generating the proceeds.[122] If the security interest in proceeds is perfected in accordance with section 9-306(3),[123] then it has the

---

117. *See* R. David Whitaker, *Letters of Credit and Electronic Commerce*, 31 IDAHO L. REV. 699, 704-05 (1995).

118. Prefatory Note, Revised Article 5, *in* 2B UNIFORM LAWS ANNOTATED 112, 113 (West Supp. 1997). For some additional history concerning the drafting process, see James E. Byrne, *Internationalization of Revised UCC Article 5 (Letters of Credit)*, 16 NW. J. INT'L L. & BUS. 215 (1995); James J. White, *The Influence of International Practice on the Revision of Article 5 of the UCC*, 16 NW. J. INT'L L. & BUS. 189 (1995) (Professor White was the Reporter for the revision of Article 5).

119. The Official Comments appear in both the Burns and West versions of the Indiana Code. For comprehensive discussion of the law of letters of credit, see JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT (rev. ed. 1996); 3 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE, ch. 26 (4th ed. 1995).

120. U.C.C. § 9-306(2) (1995). "Proceeds" is defined as including "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." *Id.* § 9-306(1).

121. *Id.* § 9-203(3) ("Unless otherwise agreed a security agreement gives the secured party the rights to proceeds provided by Section 9-306.").

122. *See id.* cmt. 2(a).

123. Under section 9-306(3), the security interest in proceeds is automatically perfected for ten days after the debtor's receipt of the proceeds. In order to remain perfected after the ten days, the secured party's situation must fall within one of three categories: (1) the proceeds are collateral

same priority as the security interest in the original collateral.[124] If the secured party has a perfected security interest in proceeds, that security interest is enforceable not only against the debtor, but also against third party transferees of proceeds,[125] and the secured party may bring an action for conversion to recover proceeds in the hands of a third party transferee.[126]

Comment 2(c) to section 9-306, however, states an apparent limit on the rule of section 9-306(2) as it applies to cash proceeds:

> Where cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in ordinary course. The law of fraudulent conveyances would no doubt in appropriate cases support recovery of proceeds by a secured party from a transferee out of ordinary course or otherwise in collusion with the debtor to defraud the secured party.[127]

Although some courts have refused to recognize "payment in ordinary course" as cutting off a security interest in proceeds because the rule is contained in a comment rather than the text of the statute,[128] most courts, including those of Indiana,[129] have recognized the payment in ordinary course limit on the ability of a secured party to recover cash proceeds transferred by the debtor to a third party.[130] Comment 2(c)'s cryptic reference to "transfers in ordinary course" versus those "out of ordinary course," however, provides little guidance for courts in determining whether a secured party may recover cash proceeds in the hands of a third party transferee from the debtor.

In *HCC Credit Corp. v. Springs Valley Bank & Trust Co.*,[131] the Indiana Court

---

that could be perfected by filing a financing statement in the office where the financing statement covering the original collateral has been filed, and, if the proceeds were acquired with cash proceeds, the description of collateral in the filed financing statement includes the type of property constituting the proceeds; (2) a filed financing statement covers the original collateral and the proceeds are identifiable cash proceeds; or (3) the secured party has independently perfected the security interest in the proceeds within the ten day period. *Id.* § 9-306(3)(a)-(c).

124. *Id.* § 9-312(6) (for purposes of the first to file rule of section 9-312(5), "a date of filing or perfection as to collateral is also a date of filing or perfection as to proceeds").

125. *See id.* § 9-201 (security agreement is effective "between the parties, against purchasers of the collateral and against creditors" except as otherwise provided in the Act).

126. Citizens Nat'l Bank v. Mid-States Dev. Co., 380 N.E.2d 1243, 1244 (Ind. App. 1978).

127. U.C.C. § 9-306 cmt. 2(c) (1995). "Cash proceeds" is defined as "[m]oney, checks deposit accounts, and the like." All other proceeds are referred to as "non-cash proceeds." *Id.* § 9-306(1).

128. *E.g.*, Linn Coop. Oil Co. v. Norwest Bank, 444 N.W.2d 497 (Iowa 1989).

129. *See Citizens Nat'l Bank*, 380 N.E.2d at 1250.

130. J.I. Case Credit Corp. v. First Nat'l Bank, 991 F.2d 1272, 1277 (7th Cir. 1993) (citing cases).

131. 669 N.E.2d 1001 (Ind. Ct. App. 1996), *trans. granted*, (Ind. Mar. 25, 1997).

of Appeals addressed the question of the appropriate contours for the payment in ordinary course exception. *HCC Credit* involved a priority dispute over proceeds of inventory between the inventory financier and a bank that received the proceeds in repayment of loans it had made to the debtor. Debtor, Lindsey Tractor Sales, Inc., was a farm machinery dealer that purchased machinery on credit from Hesston Corporation, secured by a perfected security interest in the machinery and its proceeds. Hesston assigned the security agreement to HCC Credit Corp. Under the security agreement, Lindsey was required to pay HCC the proceeds from sale of the financed equipment immediately upon sale.

In 1991, Lindsey sold fourteen tractors financed under the security agreement to the State of Indiana for $199,122. Instead of turning the sales proceeds over to HCC as required by the security agreement, Lindsey deposited the proceeds into its checking account at Springs Valley Bank & Trust Co., where they were commingled with $22,870 of non-proceeds funds. On the day after the deposit, Lindsey's president drew a $212,104.75 check on this account to the order of Springs Valley in payment of four notes Lindsey owed Springs Valley, although three of the notes were not yet due. The bank did not know that part of the funds used to pay off the notes were proceeds subject to HCC's security interest. Lindsey subsequently filed bankruptcy, and HCC brought an action against Springs Valley to recover the proceeds Springs Valley had received from Lindsey. Both HCC and Springs Valley filed motions for summary judgment. The trial court granted Springs Valley's motion.[132]

The court of appeals affirmed, finding that "under Comment 2(c), a payment is within the ordinary course if it was made in the operation of the debtor's business and if the payee did not know and was not reckless about whether the payment violated a third party's security interest."[133] With regard to the knowledge prong of this test, the court found that "[t]he critical factor is not whether the payee knew about the secured party's security interest, but whether the payee knew that the payment to it violated the security interest."[134] Here, there was no evidence to support an inference that Springs Valley knew Lindsey was violating its obligations under the security agreement.[135] The evidence also did not support any inference of reckless disregard of the fact the payment violated the security agreement.[136]

---

132. *Id.* at 1002-03.

133. *Id.* at 1005 (quoting J.I. Case Credit Corp. v. First Nat'l Bank, 991 F.2d 1272, 1279 (7th Cir. 1993)).

134. *See id.*

135. *See id.*

136. *Id.* The court specifically rejected HCC's contention that "acceptance of an unprecedently large payment by a creditor is sufficient to support an inference of recklessness." *Id.* In dissent, Judge Kirsch agreed with the knowledge/recklessness standard adopted by the court, but would have found that Springs Valley's possible knowledge of the security interest or recklessness were material questions of fact that precluded summary judgment. Judge Kirsch specifically mentioned the fact the payment at issue "was for a sum greatly in excess of any other made by the debtor" to Springs Valley in support of his conclusion. *Id.* (Kirsch, J., dissenting).

In reaching its conclusion, the court of appeals adopted both the rule and the rationale of the Seventh Circuit in *J.I. Case Credit Corp. v. First Nat'l Bank of Madison County*.[137] In *Case*, the Seventh Circuit applied Indiana law to a set of facts similar to those in *HCC*. The Seventh Circuit reasoned that, because the language of comment 2(c) seemed to equate "out of ordinary course" with "collusion," the most important factor to consider was "the payee's knowledge about whether the payment was made with money that rightfully belongs to another."[138] This conclusion was further supported by the Code's definition of "buyer in ordinary course," as one buying inter alia "in good faith and without knowledge that the sale to him is in violation of the . . . security interest of a third party."[139] The court reasoned that use of the same "ordinary course" language in both comment 2(c) and section 1-201(9) suggested that the drafters intended factors stated in section 1-201(9) to apply to determinations of "ordinary course" under comment 2(c) as well.[140]

As the court noted, "knowledge" under the Code means "actual knowledge;"[141] recklessness, however, is "a mental state that the law commonly substitutes for actual knowledge," and also is one that is inconsistent with the exercise of good faith required by section 1-201(9) in order to be in ordinary course.[142] Therefore, the Seventh Circuit concluded that the appropriate standard should be one that included not only a transferee with actual knowledge that the transfer violated the secured party's security interest, but also a transferee "who closes his eyes for fear that he may find that his accepting a payment will violate another's interests."[143]

The Seventh Circuit also believed that a broad protection for transferees of cash proceeds was justified from a policy perspective. "Imposing liability too readily on payees from commingled accounts could impede the free flow of goods and services essential to business—including credit, the 'good' supplied by the Bank—as suppliers take steps to ensure that they will ultimately not have to return the money they receive."[144]

The knowledge/recklessness standard developed by the Seventh Circuit and adopted by the Indiana Court of Appeals in *HCC Credit* makes sense. Not only does this standard make the requirements for a transferee in ordinary course parallel those for a buyer in ordinary course, but it also places the risk of loss from the debtor's misconduct with regard to proceeds on the secured party absent actual knowledge or willful avoidance of knowledge on the part of the transferee. This seems the most equitable result, as it is the secured party that has both the

137. 991 F.2d 1272 (7th Cir. 1993).

138. *Id.* at 1277. The court focused on the word "otherwise" in the phrase "out of ordinary course or otherwise in collusion with the debtor." *Id.*

139. *Id.* (quoting U.C.C. § 1-201(9) (1995)).

140. *See id.*

141. *Id.* at 1278 (quoting U.C.C. § 1-201(25) (1995)).

142. *Id.*

143. *Id.*

144. *Id.* at 1277.

motivation and the ability to monitor the debtor's control and disposition of proceeds of collateral. Broad protection of transferees of cash proceeds thus not only protects the free flow of goods and services, but encourages responsible business practices on the part of secured parties.[145]

Article 9 currently is being revised by NCCUSL and the ALI. The soundness of the conclusion that the exemption for transferees of cash proceeds in ordinary course should be a broad one is further illustrated by the treatment of this issue in the proposed revisions to Article 9. The current draft of revised Article 9 provides that "[a] transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party."[146] The revision draft's "collusion" standard, adopted from UCC Article 8,[147] is even more protective than the "actual knowledge/recklessness" standard adopted by the court of appeals in *HCC Credit.*[148]

B. Article 9 Definition of "Instrument"

---

145. The less stringent standards adopted by other courts do not further these policies as well. For instance, the district court in *Case* had adopted essentially a negligence standard for determining whether a payment was out of ordinary course, holding that the payment was not in ordinary course because the bank knew facts which "should have put a reasonable bank, exercising prudent business practices, on notice that something was awry." *J.I. Case*, 991 F.2d at 1274. This standard would place the duty to inquire into the debtor's actions with regard to proceeds on persons receiving payments from the debtor rather than on the secured party. In *Harley-Davidson Motor Co. v. Bank of New England—Old Colony*, 897 F.2d 611 (1st Cir. 1990), the First Circuit applied a standard that focussed on the payee's conduct, asking whether the payee had acted "unreasonably or improperly" and had engaged in "conduct that, in the commercial context, is rather clearly improper." *Id.* As the Seventh Circuit noted in *Case*, a court's "notion of what constitutes good commercial policy is not sufficient to decide how broadly or narrowly to define ordinary course." *J.I. Case*, 991 F.2d at 1277. (It may, however, be relevant to the court's decision as to whether to allow equitable tracing, which was the issue upon which the First Circuit was focusing in *Old Colony*.).

146. U.C.C. § 9-329(b) (NCCUSL Annual Meeting Draft July 25-Aug. 1, 1997).

147. *See, e.g.* U.C.C. §§ 8-115, 8-503(e) (1995).

148. *See* U.C.C. § 9-329 cmt. 4 (NCCUSL Annual Meeting Draft July 25-Aug. 1, 1997) (collusion standard is "the most protective (i.e., least stringent) of the various standards now found in the UCC"). The policy rationale given by the drafters for this standard is similar to that found persuasive by the courts in *Case* and *HCC Credit*:

> Broad protection for transferees helps to ensure that security interests in deposit accounts do not impair the free flow of funds. It also minimizes the likelihood that a secured party will enjoy a claim to whatever the transferee purchases with the funds. Rules concerning recovery of payments traditionally have placed a high value on finality. The opportunity to upset a completed transaction, or even to place a completed transaction in jeopardy by bringing suit against the transferee of funds, should be severely limited.

Id. cmt. 3.

Unlike Article 3's definition of "negotiable instrument," which is based on certain formal requirements to be determined from the four corners of the document,[149] Article 9 employs a functional definition of "instrument." Collateral is classified as an instrument under Article 9 not only if it is an Article 3 negotiable instrument or an Article 8 certificated security, but also if it is "any other writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment."[150]

In *Craft Products, Inc. v. Hartford Fire Insurance Co.*,[151] the Indiana Court of Appeals addressed for the first time in Indiana the issue of whether a non-negotiable, non-transferable certificate of deposit (CD) should be classified as an instrument under Article 9. The CD involved was owned by Craft Products, Inc. and held by Valley American Bank for the company. Craft, the president and sole shareholder of Craft Products loaned the company $1,285,000 secured by the CD. Craft attempted to perfect his security interest by filing in the UCC records. Apparently, he also initially retained possession of the CD, but he subsequently gave the CD to Amwest Surety Insurance as collateral for a bond. Craft Products ceased operations, and Craft foreclosed on the loan. Subsequent to this foreclosure, Hartford Fire Insurance Co. obtained a judgment against the company and attempted to garnish the CD, which by this point had been released by Amwest and was being held by Valley American Bank. Craft argued that, as a secured party with a prior perfected security interest in the CD, he had priority over Hartford. The trial court found that the CD was an instrument and that, therefore, a security interest in it could only be perfected by taking possession of the CD.[152] Because Craft did not have possession of the CD, the trial court found that Craft did not have a perfected interest in the CD and, therefore, did not have priority over Hartford's garnishment lien.[153]

Because the parties did not dispute the trial court's finding that the CD was not a negotiable instrument,[154] the issue on appeal was whether the CD was a "writing . . . which is in ordinary course of business transferred by delivery."[155] Craft argued that the legend on the CD stating that it was "non-transferrable" should be controlling on the issue. The court of appeals correctly rejected this argument, noting that under Article 9

---

149. *See* text accompanying *supra* notes 60-62.

150. U.C.C. § 9-105(1)(i) (1995).

151. 670 N.E.2d 959 (Ind. Ct. App. 1996).

152. *See* U.C.C. § 9-304(1) (1995) (security interest in an instrument other than a certificated security must be perfected by secured party taking possession).

153. *Craft Prods.*, 670 N.E.2d at 960. *See* U.C.C. § 9-301 (unperfected security interest is subordinate to rights of a lien creditor).

154. A CD can be a negotiable instrument if it meets the formal requirements for negotiability in U.C.C. section 3-104. *See* U.C.C. § 3-104(a)(1)-(3) (1990) (requirements for negotiability); *id.* § 3-104(j) (defining "certificate of deposit").

155. *Craft Prods.*, 670 N.E.2d at 961 (quoting U.C.C. § 9-105(1)(i) (1995)).

> Instead of narrowly looking to the form of the writing, a court should instead look to the realities of the marketplace. If the evidence shows that the type of writing at issue is customarily transferred in the marketplace by delivery of possession, then the requirements of Article 9 are met.[156]

Applying this test, the court of appeals found that, although the CD was labeled as non-negotiable and non-transferrable, in the "current usage of the marketplace" it nevertheless was transferable by delivery of possession, as evidenced by the fact Craft had delivered it to Amwest as security for a bond, and Amwest had returned possession of the CD to Valley American Bank when it released its interest in the CD.[157]

---

156. *Id.* (citations omitted).

157. *Id. See also* Cadle Co. v. Citizens Nat'l Bank, No. 23539, 1997 WL 368627, at *3 (W. Va., July 3, 1997) (collecting cases).