

Diagramming Commercial Paper Transactions

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I. INTRODUCTION

The authors of one of the leading casebooks on commercial law have indicated that “[u]nless he has the advantage of some business background, the law student is likely to find the law of negotiable commercial paper, at least at the outset, the most esoteric and intractable area of commercial law.”¹ Encountering these burdens, the resistance of law students and the confusion of many courts with respect to the law of commercial paper becomes more appreciable.

This area of the law is so intractable largely because it invokes multiple legal theories that often involve multiple participants. Even when the facts of a case are not particularly complicated, the numerous points of interplay among legal concepts and the several parties makes the conceptualization difficult for persons who have not attained a degree of facility with this area of the law. When something goes wrong in a commercial paper transaction, a number of different legal actions are often possible through which liability can be passed from one party to another. An approach to this subject area that assists in the visualization of the relationships among the parties should promote understanding of commercial paper law.

This Article provides an approach to improve the comprehension of commercial paper transactions. It describes a simple, easily understood system to diagram the relevant facts of commercial paper cases and hypotheticals.² By showing graphically the relationships among the parties upon which the legal approaches in these cases depend, the diagrams improve understanding of how the legal principles operate.

II. DIAGRAMMING AND CHARTING IN GENERAL

Law students attempting to understand a subject matter often engage in frustrating exercises. Because they recognize that visualization of a concept through a diagram or chart can be very beneficial, they diagram various fact patterns or concepts or try to design a flow chart that will enable them to “pull together” the concepts and to perceive how they are interrelated. The results of these efforts usually are inadequate to satisfy the desire for comprehensive understanding of the subject.

The efforts generally are doomed from the outset due in part to the nature of the subject matter. The diagrams of individual issues or cases can be very helpful in their specific context, but they lack a principle of integration to bring

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1. E. FARNSWORTH & J. HONNOLD, *CASES AND MATERIALS ON COMMERCIAL LAW* 48 (2d ed. 1976).

2. I developed and refined the diagramming system initially for use in the classroom. The receptiveness of the students to the system convinced me to use it also in my treatise on commercial paper. See W. LAWRENCE, 1 & 2 *COMMERCIAL PAPER AND PAYMENT SYSTEMS* (1990).

them together. The attempt to create a flow chart of the subject area fails because the relevant body of law and its application simply are not conducive to such a methodology. Consequently, many of the charts that are developed are so complicated that they require detailed explanations in order to understand them. The effort of developing the chart certainly may benefit the individual who struggles with it, but it is not a useful medium of explanation for others. Less complicated charting efforts of an entire subject area are necessarily so broad and generalized that the visualization does not serve to advance conceptualization.

Even a subject area like Article 9 of the U.C.C. on secured transactions, which conveniently breaks down into only five basic parts (scope, attachment, perfection, priorities, and default), does not lend itself to a consistent diagramming scheme. A more effective method for comprehensive coverage of secured transactions is to develop an outline that utilizes these broad areas and proceeds from generalized concepts to specialized applications and exceptions.

Another flaw that plagues a flow chart approach is that it does not incorporate relevant factual contexts. An understanding of an area of the law requires the ability to apply it, and application cannot occur in a factual vacuum. A flow chart essentially is a check list or a "road map" in chart form. Since relevant facts can lead to so many different directions in most areas of the law, the flow chart becomes a veritable thicket that tends to obfuscate rather than enlighten.

The combination of these shortcomings undercuts the usefulness of a diagramming or a charting scheme as a pervasive approach to most legal subjects. Diagrams, charts, roadmaps, and checklists can be very useful in limited contexts. Law professors commonly utilize them on the blackboard throughout the instruction of a course. Legal publications also occasionally incorporate a diagram, and some are devoted to the explanation of a valuable graphic technique.³ Diagrams, however, generally do not provide a tool that can be applied consistently to create a visualization of specific factual situations in an entire subject area. The inability to utilize a simple and consistent diagramming scheme throughout an entire subject area probably explains why diagrams are not more commonly utilized as an instructional technique in teaching materials.

III. DIAGRAMMING COMMERCIAL PAPER

The law of commercial paper is unique in its adaptability to a comprehensive diagramming technique. An easily understood system of diagramming facts can be applied to commercial paper and bank collection transactions. The consistency of the approach facilitates understanding of the subject matter. The diagramming scheme thus can be used beneficially by professors, students, practitioners, and courts.

3. See, e.g., H. HENN, *CORPORATIONS: CASES AND MATERIALS* 83 (1974) (diagram shows the relationship among directors, officers, shareholders, and a corporation); 9 J. WIGMORE, *EVIDENCE* §2487, at 298 (J. Chadbourn rev. 1981) (diagram shows the difference in the burdens of production and persuasion); Richman, *Diagramming Conflicts: A Graphic Understanding of Interest Analysis*, 43 OHIO ST. L.J. 317 (1982) (develops a diagramming scheme to portray Brainerd Currie's governmental interest analysis for conflicts of law resolution); Tribe, *Triangulating Hearsay*, 87 HARV. L. REV. 957, 959 (1974) (diagram shows basis to distinguish hearsay from nonhearsay).

The critical features of the law of commercial paper that facilitate a comprehensive diagramming approach are the factual flow of such paper and the relationship of the legal structure to that flow. The facts of commercial paper cases and problems turn largely on the transfer or the wrongful acquisition of the paper. These movements of an instrument through successive participants toward payment or dishonor represent the downstream flow.⁴ The diagramming scheme shows this flow of paper to each of the participants and the relevant actions that each participant takes with respect to the paper. The initial benefit of the diagram is that it provides a concise visualization of the ordered relationships of the participants to the paper's movement.

This visualization of these relationships is advantageous because most of the legal rights and liabilities that comprise the law of commercial paper stem from the relationships established in this downstream flow.⁵ The nature of any participant's commercial paper liabilities depends upon that party's actions toward the paper and the actions of other participants.⁶ In exercising rights on commercial paper, a party may be able to proceed downstream against subsequent parties or upstream against prior participants.⁷ The diagrams assist in perceiving the factual context toward which the relevant approaches apply.

In multiple-party transactions involving commercial paper the issue often becomes one of ascertaining ultimate liability. Drawing upon a wide range of theories of commercial paper, grounded primarily in principles of contract,⁸ personal property,⁹ torts,¹⁰ warranty,¹¹ and prevention of unjust enrichment,¹² a given participant may be able to pass initial liability to another party. That party, in turn, may be able to proceed either downstream or upstream against yet another participant, and so on, until ultimately someone involved with the

4. The stream metaphor was initially introduced by Professors White and Summers to distinguish plaintiffs "who sue 'down-stream' and those who sue 'up-stream.'" J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 653 (3d ed. 1988).

5. For example, contract and warranty liability—two of the major theories of liability that apply in all commercial paper transactions—are based on the downstream flow of the paper. U.C.C. §§ 3-413, 3-414, 3-417, 4-207 (1990). The contracts of some accommodation parties are an exception to this basic principle. *Id.* § 3-415(5).

6. For example, "[n]o person is liable on an instrument unless his signature appears thereon." *Id.* § 3-401(1). Therefore, if someone signs the payee's name to a check, the signor generally is bound but the person whose name is signed is not obligated. *Id.* § 3-404. The result is different, however, if the person named authorized the signature, *id.* § 3-403, or if negligence of the party substantially contributed to the unauthorized signature. *Id.* § 3-406.

7. For example, if a check drawn to the order of a payee is paid by the payor bank after a thief steals it from the payee and forges the payee's indorsement, the payee would have several options, provided negligence of the payee did not substantially contribute to the forgery. The payee could maintain an action upstream against the drawer for a lost or stolen instrument. *Id.* § 3-804. The payee alternatively could sue the downstream payor bank for conversion. *Id.* § 3-419(1)(c) (payment on a forged indorsement). The payee also has the right to proceed directly against the thief for common law conversion. *Id.* § 1-103.

8. *Id.* §§ 3-413 (contracts of maker, drawer, and acceptor), 3-414 (contract of indorser), 3-415 (contract of accommodation party), 3-416 (contract of guarantor). Part 4 of Article 4 is also based on an underlying deposit contract between a customer and a drawee bank.

9. *Id.* § 3-201 (rule of derivative title).

10. *Id.* §§ 3-405 (negligence with respect to impostors and fictitious payees), 3-406 (negligence contributing to alteration or unauthorized signature), 3-419 (conversion), 4-406 (negligence in examining bank statement and returned checks).

11. *Id.* §§ 3-417 (warranties outside bank collection process), 4-207 (warranties within bank collection).

12. *Id.* §§ 3-418 (restitution), 3-804 (recovery of lost, destroyed, or stolen instruments), 4-407 (subrogation).

instrument will have to respond for the loss but not be able to pass it along to anyone else.¹³ Thus, a number of distinct options might be pursued by aggrieved parties. It is critical in the application of the law of commercial paper to understand the precise nature of liability incurred by a given participant and precisely *to whom it runs*.¹⁴ A merit of the diagramming scheme is that it sharpens this perspective and facilitates its application.

A final advantage of this diagramming approach is its workability. The same symbols can be used for the entire subject matter. In the classroom, the symbols can be introduced progressively as new concepts are introduced, rather than all at once. Furthermore, the symbols are not selected arbitrarily but rather are chosen purposely so that they may aid functionally in the conceptualization of the material.¹⁵ Finally, despite the fact that the subject matter of commercial paper law is highly technical and interrelated, the diagramming system itself remains remarkably simple. My experience has shown that students assimilate the system quickly and utilize it as a valuable tool throughout their study of the subject matter.

IV. ILLUSTRATIONS OF THE DIAGRAMMING SCHEME

The remainder of this Article explains the major elements of the diagramming scheme. It is not a complete discussion of all cases, but nevertheless should be sufficient to demonstrate the approach.

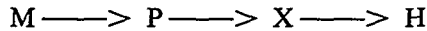
A single set of abbreviations is used consistently to refer to the most common actors and relevant events in commercial paper activity. This set of abbreviations is as follows: D'or = drawer; D'ee = drawee; M = maker; P = payee; DB = depository bank; IB = intermediary bank; PB = payor bank; T = thief; F = finder; H = holder; HICD = holder in due course; BI = bearer instrument; OI = order instrument; AP = accommodation party; E = employee. Additional transferees are identified in the order in which they take the instrument by a progressive string of letters from the alphabet, such as X, Y, and Z.

13. If the payee in the illustration provided in note 7 were to pursue either of the first two options, the defendants in those options would utilize other causes of action to successfully pass the loss on to another participant. If required to issue another check to the payee, the drawer could proceed downstream against the payor bank to require the bank to recredit the drawee's account for the check already paid. *Id.* § 4-401 (check not properly payable with forged indorsement). With liability passed to the payor bank under either option, the bank could proceed upstream on a breach of warranty theory against the presenter and all prior transferors up to and including the thief. *Id.* §§ 4-207(1)(a), 3-417(1)(a) (breach of warranty of good title). If the payor bank proceeded against any of these parties other than the thief, the ultimate liability would come to lie on the thief through the use of transferors' warranty provisions. *Id.* §§ 4-207(2)(a),(b),(d), 3-417(2)(a),(b),(d). If the thief cannot be found or is insolvent, the ultimate loss would come to rest on the first solvent party downstream from the thief.

14. For example, the preamble provision for each subsection that identifies warranties delineates the parties who give the warranties and to whom they run. *See, e.g., id.* § 3-417(1) ("[a]ny person who obtains payment or acceptance and any prior transferor warrants to a person who in good faith pays or accepts"). *See also id.* §§ 3-417(2), 4-207(1),(2). The sections on the contracts of secondary parties are also very explicit in stating the nature of the contract liability and the parties to whom it extends. *See, e.g., id.* § 3-414(1) (indorser engages that upon satisfaction of the statutory conditions "he will pay the instrument according to its tenor at the time of his indorsement to the holder or to any subsequent indorser who takes it up"). *See also id.* § 3-413(2).

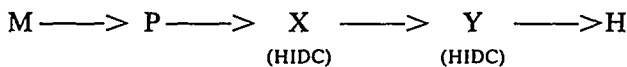
15. For this reason, I prefer to use these functional symbols even when diagramming the facts of an actual case. When identification of the location of the specific named parties in a diagram is a concern, abbreviations of the parties' names can be added in the diagram to accompany the symbols.

A solid arrow is used to indicate a transfer of the instrument between two parties. It is the clearest possible sign that one party has passed the instrument directly to another party.



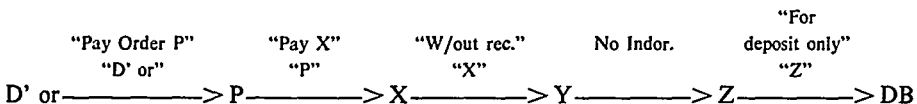
The diagram above shows that a maker issued an instrument to a payee. The payee in turn transferred it to X, and that party transferred it to a party who qualifies as a holder. It is implicit in this diagram that each transfer had to be by negotiation; otherwise the last party could not qualify as a holder.¹⁶

Holder in due course status can also be indicated in the diagrams. If the holder in the diagram above qualified, this additional status could be indicated by simply designating the party as HIDC. Sometimes, however, the analysis focuses on more than one party who took an instrument as a holder in due course. The diagram can be prepared as follows:



This type of diagram can be very useful to demonstrate both the limitations on the rights of holders in due course¹⁷ and the shelter principle.¹⁸

When the substance of indorsements are relevant to the analysis, cryptic indications of relevant indorsements can be included within quotation marks above the arrow that indicates any given transfer. The quotation marks indicate that the language and the signature were written by the transferor. Similar references can be made for relevant language provided by the issuing party on the face of the instrument. A diagram of a lengthy flow of paper is provided below to illustrate the numerous possibilities.



This diagram shows that a drawer issued an instrument payable to the order of the payee. The payee, in turn, made a special indorsement¹⁹ to X and transferred the instrument accordingly. X then made an indorsement that was qualified²⁰ and in blank²¹ and transferred the instrument to Y. Y proceeded to transfer the instrument to Z without indorsing it at all. Z then indorsed both restrictively²² and in blank and transferred to a depository bank. Any language

16. U.C.C. §§ 3-202(1), 1-201(20).

17. Y would take free of a personal defense of P, but X would not because X dealt with P. *Id.* § 3-305(2).

18. Even though H does not qualify as a holder in due course, H takes free of P's personal defenses. *Id.* §§ 3-201, 3-305(2). The interplay of these provisions can be illustrated concisely by changing material features in the diagram. For example, H's shelter rights will not be sufficient against personal defenses of P if Y is eliminated as a participant or if Y did not take the instrument as a holder in due course. *Id.* §§ 3-201, 3-306(b).

19. *Id.* § 3-204(1) (specified the person (X) to whom the instrument was made payable).

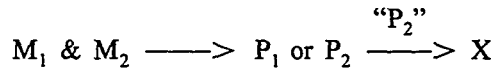
20. *Id.* § 3-414(1) (disclaimed contract liability).

21. *Id.* § 3-204(2) (mere signature without designation of a particular indorsee).

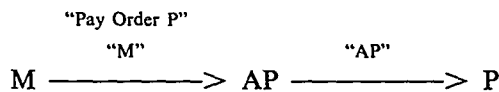
22. *Id.* § 3-205(c) (includes the words "for deposit").

or indorsement that is not material to the specific analysis can be eliminated entirely in order to keep the diagram as clean as possible. Similarly, the issue of the instrument from the drawer to the payee might indicate OI for order instrument or BI for bearer instrument, or it might carry the designation of check, note, or draft if that information is important.

Cases involving joint transferors or accommodation parties can also be easily indicated in the diagramming scheme. Consider the following diagram:



The two makers in the diagram are jointly and severally liable.²³ However, a diagram showing the makers as "M & AP" indicates that the second maker has signed as an accommodation party. The diagram provided above shows that the instrument was issued to two payees in the alternative. The single indorsement by only one of them was, therefore, sufficient to negotiate the instrument to X.²⁴ If the instrument had not been payable to the payees in the alternative ("P₁ & P₂"), the single indorsement would not have been sufficient for negotiation.²⁵ An accommodation indorser can be diagrammed as shown below:



The diagram shows that the indorsement of the accommodation party is outside of the chain of title.²⁶ A diagram in which the positions of M and AP are reversed, so that the accommodation party signs as a maker and the party accommodated signs as an indorser, is useful in demonstrating the exceptional circumstance in which a party can proceed downstream on a contract cause of action.²⁷

An important distinction, but one that is not readily apparent from the codification of Articles 3 and 4, is that a presentment for payment is not a transfer.²⁸ The distinction is critical to an understanding of the difference between transferors' and presenters' warranties.²⁹ The diagramming scheme,

23. *Id.* § 3-118(e).

24. *Id.* § 3-116(a).

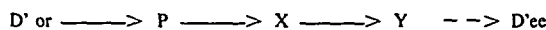
25. *Id.* § 3-116(b).

26. *Id.* § 3-415(4).

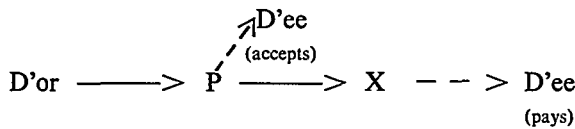
27. "An accommodation party is not liable to the party accommodated, and if he pays the instrument has a right of recourse on the instrument against such party." *Id.* § 3-415(5). Thus, if the accommodation maker were required to pay the instrument, he or she could proceed downstream to assert the recourse right against the accommodated party who indorsed.

28. Although the holder voluntarily gives up possession upon payment, thus appearing to transfer the instrument to the payor, the relinquishment of possession of the instrument to the payor upon its payment is surrender of the instrument and not a transfer. *Id.* § 3-505(1)(d) (party upon whom presentment of an instrument is made has the right to require "its surrender upon full payment"). This approach is consistent with common law. See *National Bank of Commerce v. Seattle Nat'l Bank*, 109 Wash. 312, 187 P. 342 (1920).

29. Transferors' warranties do not run to persons who pay or to payor banks. These paying entities, as well as parties who accept, purportedly receive a less extensive array of warranty protection. U.C.C. § 4-207 (1990), Official Comment 4.

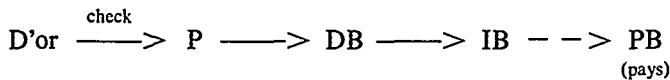


therefore, uses a dotted line with an arrow to indicate presentment. An arrow is used because one party presents directly to another party.³⁰ Using a dotted line in each instance provides a visualization that distinguishes presentment from transfers because transfers are indicated by solid lines in the arrow. Presentment also is made either for acceptance or for payment.³¹ Because a presentment for acceptance results in return of the instrument to the presenter even when accepted, whereas an instrument is surrendered when paid following presentment for payment, presentment for acceptance is not part of the downstream flow of the paper. The diagramming scheme visually maintains this distinction between presentment for acceptance and presentment for payment by showing presentment for payment as the terminus of the downstream flow³² and keeping presentment for acceptance outside of the flow.



This diagram shows that after receiving issuance of an instrument from the drawer, the payee presented it to the drawee for acceptance and the drawee accepted. The payee thereafter transferred to X, who then presented for payment to the drawee, and the drawee paid. If the drawee had not been so obliging following either of the presentments, that fact can be indicated by substituting the word dishonors inside the relevant parentheses.

The use of the distinct symbol for presentment is very helpful in facilitating an understanding of check collection cases like the one diagrammed below.



It drives home the point that presentment can be made only upon the bank that the drawer has ordered to pay. The payee's relationship with the depository bank is a transfer, not a presentment, and that bank has not paid the check to the payee even if it has given cash to the payee at the time of the transfer.³³

In the diagram above, the presenter's warranties run from all of the prior parties to the drawee. *Id.* § 3-417(1). Transferors' warranties are extended by each party that transfers, but these warranties do not extend to the drawee. *Id.* § 3-417(2).

30. "Presentment is a demand for acceptance or payment made upon the maker, acceptor, drawee or other payor by or on behalf of the holder." *Id.* § 3-504(1).

31. *Id.* §§ 3-501(1), 3-504(1).

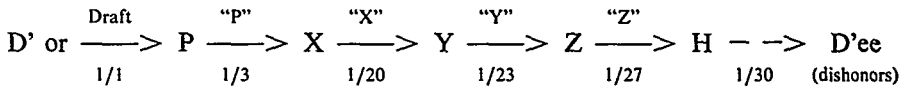
32. The payment of a note by a maker is also indicated at the end of the downstream flow, even though a note begins its flow with issuance by the same maker. The following simple diagram is illustrative.



This visualization is helpful to conceptualize the legal relationships among the parties. For example, if M pays the note, P will have made warranties that extend to both X and M. *Id.* § 3-417(2), (1).

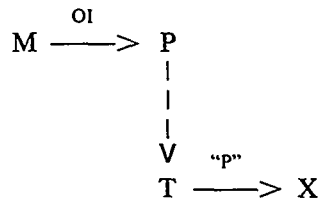
33. The depository bank has agreed to collect the check for its customer and has made a cash advance against the security of the check. *See id.* § 4-208(1)(c).

Since untimely actions can have adverse consequences when dealing with commercial paper,³⁴ the dates of the transfers or other actions are important in some cases. When the dates of a transfer are relevant, they can be indicated under the arrow for each transfer. Because these dates generally are not included in transactions like indorsements, the information is not enclosed in quotation marks in the diagram.



The diagram above shows the date of each transfer and of the presentment for payment. This simple diagram of the facts makes it easier to envision application of the Code rules concerning timely presentment and notice of dishonor in order to retain the liability of the parties who have signed the instrument, as well as to visualize the resulting relationship among the parties that remain liable following the discharges.³⁵

An event that can have significant ramifications, as well as lead to some of the most difficult statutory construction issues, is the theft of an instrument on which the thief forges an indorsement. The theft of an instrument results in its movement from a possessor to the thief, but it is not transferred to the thief and its acquisition is wrongful. Acquisition of the instrument by theft, therefore, is indicated in a diagram by an arrow running downward.



The diagram above indicates that a payee received the issuance of an order instrument from a maker only to have it stolen by a thief. The thief forged the payee's indorsement in blank and transferred the instrument to X. Article 3 will make the thief, not the payee, contractually liable on the indorsement because the signature was made by the thief.³⁶ The thief does not acquire holder status and cannot negotiate the instrument to X because of the missing necessary indorsement of P.³⁷ The simple diagram provides an appropriate visual reference

34. *Id.* § 3-502(1) (discharge of secondary parties for unexcused delay of necessary presentment or notice of dishonor).

35. The presentment is within the thirty-day presumption for the reasonable time for presentment with respect to the drawer. *Id.* § 3-503(1)(e), (2)(a). The presentment is not timely with respect to indorsers P and X, however, as it is clearly outside the presumption of seven days. *Id.* § 3-503(1)(e), (2)(b). P and X are thus discharged. *Id.* § 3-502(1)(a). The presentment is just within the time limit for Y. In the classroom, facts can be easily manipulated concerning notice of dishonor to demonstrate the operation of § 3-508.

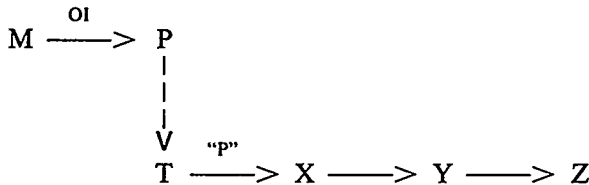
36. *Id.* § 3-404(1).

37. *Id.* §§ 1-201(20), 3-202(1), 3-301.

for the application of these rules of Article 3.³⁸ A finder's role in the downstream flow would be diagrammed similarly.

In addition to distinguishing a theft from a transfer, the use of downward arrows to indicate thefts provides the additional advantage of helping to explain some serious drafting problems in Article 3. Section 3-417(2) provides that transferors' warranties extend beyond a transferor's immediate transferee when the transfer is by indorsement. Unfortunately it also states that these warranties run to only subsequent holders. Application of the statutory language would lead to the undesirable effect of limiting transferors' warranty liability to the immediate transferees of persons who forge necessary indorsements on the instruments they transfer, because no subsequent transferee of an instrument with such a forged indorsement can attain holder status. Some commentators have identified the problem in this section and contended that the limiting result should be ignored as violative of the actual drafting intent.³⁹

Professor (now Judge) Ellen Peters has proposed a helpful legal fiction of treating the transfer of the instrument with the forged indorsement as the creation of a "new" instrument and recognizing that the subsequent parties are "holders" of this new instrument.⁴⁰ This legal fiction is a very helpful mechanism to reach the desired approach, and it can be justified on policy grounds.⁴¹ The diagramming scheme facilitates an understanding of its application because, beginning with the transfer from the forger, it places all of the subsequent parties on a different level.



The above diagram facilitates the explanation that, despite the actual codification of section 3-417(2), T, X, and Y should be held to have breached the first, second, and fourth transferors' warranties respectively, and that their liability

38. If the instrument had been issued as bearer paper, or if P had indorsed in blank prior to the theft, the thief would acquire holder status and a further indorsement would not be necessary to negotiate the instrument further. The facts in this simple diagram can be changed to demonstrate the relationship of these provisions.

39. J. WHITE & R. SUMMERS, *supra* note 4, at 682 n.9 (3d ed. 1988).

40. E. PETERS, *COMMERCIAL TRANSACTIONS: CASES, TEXT AND PROBLEMS ON CONTRACTS DEALING WITH PERSONALTY, REALTY AND SERVICE* 1430-31 (1971).

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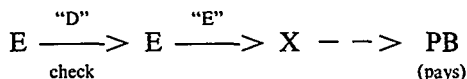
In the early common law cases, liability was imposed on the indorser by arguing that, upon indorsement, he had engrafted a new bill of exchange upon the transferred instrument. Although Article 3 does not describe the indorser in these terms, there are situations in which this concept remains useful. For example, despite the fact that the forgery of an indorsement prevents subsequent takers from qualifying as holders of the original instrument, the warranty against forged indorsements is described in Section 3-417(2)(a) as running to holders. Under the new bill doctrine, the beneficiaries of the warranty can be protected as holders of the bill created by the legitimate indorsement even though they cannot be holders of the instrument with the forged indorsement.

Id.

should extend to all of the downstream parties, not only to their immediate transferees.

The last diagram is also useful in demonstrating that the drafting problems created in forged indorsement cases are even greater than generally recognized. T's forgery of the indorsement of P binds T on the indorsement contract,⁴² but under a literal reading of section 3-414(1) T's contract liability does not extend to Z. Without the legal fiction approach, Z cannot qualify as a holder, even though Z's predicament is entirely the result of T's forgery. Professor Peters' fiction should apply equally in this context to find that Z is the "holder" of the "new" instrument of T. The diagram again promotes understanding of this analysis.⁴³

The use of the separate level of transfers in the diagram created by using downward arrows to represent thefts also provides significant benefits when contrasting cases involving forged drawers' and forged makers' signatures. None of the drafting problems described above concerning holder status under the Code apply to these types of cases. Forged indorsements and forged drawers' signatures are treated very differently, and the diagramming scheme advances the conceptualization of the distinctive treatment.



The above diagram shows that the dishonest employee forged the signature of D as the drawer and issued the check to himself. E then indorsed in blank and transferred the check to X who presented and received payment from the payor bank. This diagram is very helpful in demonstrating that subsequent transferees qualify as holders of the check,⁴⁴ that the warranty of good title has not been breached by E's forgery,⁴⁵ and that, for purposes of the warranty of good title, the issuance of an instrument with a forged drawer's signature is equivalent to the issuance of that instrument with signature in the forger's own name.⁴⁶

Discussion of one final type of commercial paper problem should suffice to demonstrate the approach of the diagramming scheme. Alterations to an instru-

42. *Id.* § 3-404(1).

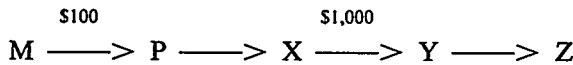
43. The fiction is also helpful in overcoming the dilemma under § 3-406 of reaching the payee if the payee's negligence substantially contributed to the forgery by T. If the instrument is dishonored by the drawee because of the forgery, warranty liability can be used by the downstream parties to pass the liability to X, who in turn could use warranty liability to reach T. Thieves are notoriously poor defendants in these types of cases, however, so X is likely to be in a position of needing to use § 3-406 against P. The estoppel of the provision does not appear to be available, however, because X is not the drawee or other payor of the instrument and does not qualify as a holder in due course, despite the requisite bona fides, because the forgery prevents holder status. Under the legal fiction, however, T's forgery and transfer would be considered the issuance of a "new" instrument, and as a "holder" of this instrument X would be in a position to establish holder in due course status. P's negligence would then preclude P from asserting the forgery against X.

44. The employee used D's name as the drawer as a necessary means to facilitate his deception. The check, however, is the employee's order to pay, and that order runs to the downstream parties.

45. "The weight of authority among cases and commentators supports a specialized instruction of the term 'good title' as it is used in this context, limiting its reference to the validity of the chain of necessary indorsements." *Sun 'N Sand, Inc. v. United Cal. Bank*, 21 Cal. 3d 671, 684, 582 P.2d 920, 930, 148 Cal. Rptr. 329, 339 (1978). See also *Bagby v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 491 F.2d 192, 199 (8th Cir. 1974).

46. U.C.C. § 3-404(1)(1990).

ment can be diagrammed to show the original terms and how a specific party changed them. Since both contract and warranty liability of the parties depends upon the point in the downstream flow at which the alteration occurs,⁴⁷ the diagram provides a convenient visual representation of the critical facts to which the statutory provisions apply.

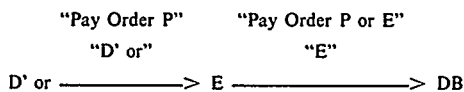


This diagram shows that a maker issued an instrument for \$100 to the payee, who in turn transferred it to X. X altered the instrument to read \$1,000 and transferred it to Y, who in turn transferred it to Z.⁴⁸ The contractual undertaking of both M and P was only for \$100, whereas X and Y incurred contracts for \$1,000.⁴⁹ X and Y also obviously breached the transferors' warranty against material alteration.⁵⁰

One of the well-known material alteration cases is a good choice to demonstrate how the diagramming approach is sometimes useful in developing alternative analysis of a case. In *Unadilla National Bank v. McQueer*,⁵¹ McQueer issued a note to Johnson's Garage that was due in five days from date, which would have fallen on March 22. He paid the note to the payee on April 1, but did not receive the note. The payee in the interim had negotiated the note to the bank on March 28. Employees of the bank asserted in their affidavits that when it was negotiated to the bank the note was payable in forty-five days, or May 1. Upon refusal of McQueer to pay when demand was made by the bank on May 1, the bank commenced an action. The appellate court reversed the trial court's award of summary judgment for the bank on the grounds that a material issue of fact existed as to the time during which the alteration had been made. The legal consequences vary greatly depending upon whether the alteration occurred before or after negotiation of the note to the bank.

47. *Id.* § 3-414(1) (indorser engages to pay instrument "according to its tenor at the time of his indorsement"); *id.* § 3-407(2)(a) (discharge of party whose contract is changed by alteration); *id.* § 3-417(1), (2) (warranties against material alteration determined as of time of transfer or presentment).

48. Other types of alterations can be diagrammed as well.



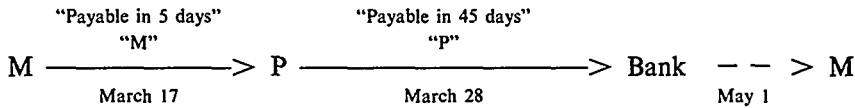
In this diagram a drawer prepared an instrument with P as the payee and gave it to an employee to deliver. The employee dishonestly added his own name as an alternative payee and indorsed the instrument before depositing it in the depository bank.

49. U.C.C. §§ 3-413(1), 3-414(1) (engagement to pay the instrument according to its tenor at the time of making the engagement). The provisions of § 3-407 determine the extent to which M or P will be discharged from their liability because of the alteration.

50. *Id.* § 3-417(2)(c).

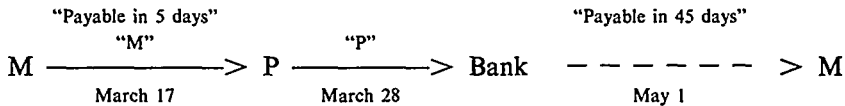
51. 27 A.D.2d 778, 277 N.Y.S.2d 221 (1967).

The necessary version of the facts for the bank to prevail is diagrammed below.



Under this version of the facts the bank could qualify as a holder in due course,⁵² cut off the defense of payment,⁵³ and enforce the instrument according to its original tenor.⁵⁴ A note payable on March 22nd would still be payable on May 1 when the demand for payment was made. The payee's alteration of the note arguably would be attributable to the necessity of making the note payable after the date for negotiation to the bank. Otherwise, the bank would not purchase the note when overdue because holder in due course status would be precluded.⁵⁵

The following version of the facts was also possible on the basis of the information before the court.



Under these facts the bank would have made the mistake of taking the note when it was overdue. Someone in the bank then decided to alter the payable date so that holder in due course status could still appear to be attained. This alteration, however, would have the effect of discharging the contract liability of the maker.⁵⁶

V. CONCLUSION

Multiple legal theories affecting multiple participants make many commercial paper transactions difficult for students and courts to analyze. This Article explains a simple, yet comprehensive diagramming scheme of the facts of these transactions that facilitates the application and understanding of the relevant legal principles.

The diagrams visually demonstrate the downstream flow of commercial paper and the relevant actions taken by the respective participants in this flow. They do not incorporate the legal provisions that affect the relationships among the participants or the policies that underlie the substantive provisions. The diagrams, however, do reduce the relevant facts to a convenient form that keeps them before the mind, thereby facilitating both analysis and discussion.

52. The major issue concerning this status would turn on whether the alteration was so apparent that the bank should have noticed it. *Id.* §§ 3-302(1)(c), 3-304(1)(a).

53. *Id.* §§ 3-305(2), 3-602.

54. *Id.* § 3-407(3).

55. *Id.* § 3-302(1)(c).

56. *Id.* § 3-407(2)(a).