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Sarah Howard Jenkins

*University of Arkansas at Little Rock William H. Bowen School of Law, shjenkins@ualr.edu*

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# GENERAL ARTICLES

## A PAYEE WHO IS A HOLDER IN DUE COURSE MAY BE SUBJECT TO PERSONAL DEFENSES ARISING FROM UNAUTHORIZED ACTS OR PROMISES BY AN AGENT

SARAH HOWARD JENKINS\*

### INTRODUCTION

While third parties are not required to “deal with” another’s agent,<sup>1</sup> modern commercial transactions often necessitate transacting with another through an agent. Even in consumer transactions, a buyer’s mundane task of purchasing goods from a local appliance dealer or a national concern generally involves “dealing with” another through its agent.

Corporations, partnerships, investors, estates, incompetents, and litigants, for example, act through agents or fiduciaries.<sup>2</sup> If a third

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\* Assistant Professor of Law, Memphis State University School of Law. B.A., 1969, Hanover College; M.A., 1970, J.D., 1982, University of Kentucky. The author is indebted to the following individuals for their kind assistance and support: Professor J. Dennis Hynes, University of Colorado at Boulder, for his review of and comments on Parts II & III; Associate Dean Carroll Stevens, Yale Law School, Professor John Garvey, University of Kentucky College of Law, and Professors John C. Carter and Robert Banks, Jr., Memphis State University School of Law, for their comments on the readability of this Article for individuals without expertise in article three of the Uniform Commercial Code; graduate assistants Ms. Helen Durham, Part I, and Ms. Holly Williams, Parts II & III, for their diligence; my brethren in Christ who have made this work a matter of persistent prayer; and Elizabeth Jenkins for her patience and support.

1. See *Mussey v. Beecher*, 57 Mass. (3 Cush.) 511, 517 (1849).

2. “An agent is a fiduciary with respect to matters within the scope of his agency.” RESTATEMENT (SECOND) OF AGENCY § 13 (1958) [hereinafter RESTATEMENT]. A fiduciary is “a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking.” *Id.* at comment a. Trustees, executors, and guardians are fiduciaries but not agents if they lack the power to impose personal liability on those for whom they act and if those for whom they act lack control over the actions of the trustee, executor, or guardian. See H. REUSCHLEIN & W. GREGORY, HANDBOOK ON THE LAW OF AGENCY AND PARTNERSHIP § 2 (1979); RESTATEMENT § 12 comment c; Seavey, *The Rationale of Agency*, 29

party as a debtor, or an obligor—one who promises or engages to perform a duty under a contract including a negotiable instrument<sup>3</sup>—uses an agent to negotiate<sup>4</sup> or issue<sup>5</sup> a negotiable instrument<sup>6</sup> when dealing with these entities or persons,<sup>7</sup> article three of the Uniform Commercial Code (U.C.C.)<sup>8</sup> will govern the rights and duties of the parties on the instrument and in some cases determine the rights remaining, if any, on the underlying obligation.<sup>9</sup> Similarly, these “persons,” corporations, partnerships, etc., as obligors,<sup>10</sup> must act or deal through their agents when issuing or negotiating instruments to their creditors or their creditors’ agents. Thus, either the payee or the obligor to a commercial transaction involving a negotiable instrument may be represented in a transaction by an agent.

In pre-U.C.C. cases, courts differed on whether a payee, one to whom a check, note, or draft is drawn or made payable,<sup>11</sup> could be a holder in due course.<sup>12</sup> Some courts held that payees could not be hold-

YALE L.J. 859, 867-69 (1920).

3. BLACK’S LAW DICTIONARY 971, 968 (5th ed. 1979) [hereinafter BLACK’S].

4. An instrument is negotiated when it is transferred in such a form that the transferee becomes a holder. AMERICAN LAW INSTITUTE, UNIFORM COMMERCIAL CODE § 3-202(1) (10th ed. 1987) [hereinafter U.C.C.] (Official Text & Comments of the Uniform Commercial Code promulgated by the National Conference of Commissioners on Uniform State Laws and the American Law Institute).

5. Unless the context otherwise requires, the first delivery of an instrument to one who is a holder or a remitter is the issuance of an instrument. U.C.C., *supra* note 4, at § 3-102(1)(a). A remitter is one who purchases or borrows a negotiable instrument that is payable to another with the consent of the obligor, drawer, maker, or acceptor. The negotiable instrument is used by the remitter for his own benefit. W. BRITTON, HANDBOOK OF THE LAW OF BILLS AND NOTES 177, at § 75 (2d ed. 1961); Moore, *The Right of the Remitter of a Bill or Note*, 20 COLUM. L. REV. 749, 751 (1950).

6. A negotiable instrument is a written contract which meets the requisites of § 3-104 of the Uniform Commercial Code. *See generally* E. PETERS, *A Negotiable Instruments Primer* (2d ed. 1974).

7. Section 1-201(30) defines “person” as including an individual or an organization. “Organization” includes a corporation, government or governmental subdivision or agency, business trust, estate, trust, partnership or association, two or more persons having a joint or common interest, or any other legal or commercial entity. U.C.C., *supra* note 4, at § 1-201(28).

8. U.C.C., *supra* note 4, at art. 3.

9. Subject to an agreement between the parties, an underlying obligation is discharged if the instrument taken in satisfaction of the obligation is drawn, issued, or accepted by a bank without providing for recourse against the remitter. Therefore, if the remitter is not a co-maker or indorser, the party taking the instrument in satisfaction of a duty owed by the remitter on an underlying transaction must solely look to the instrument and the parties thereto for satisfaction. U.C.C., *supra* note 4, at § 3-802(1)(a). *See Meckler v. Highland Falls Sav. & Loan Ass’n*, 314 N.Y.S.2d 681 (N.Y. Sup. Ct. 1970).

10. BLACK’S, *supra* note 3, at 971.

11. *Id.* at 1016.

12. A holder in due course is one who takes a negotiable instrument for value, in

ers in due course;<sup>13</sup> others held a contrary opinion.<sup>14</sup> The presence of an agent or a remitter<sup>15</sup> or other intermediary in some instances assisted the payee in his acquisition of "holder in due course" status.<sup>16</sup> A payee who attains holder in due course status obtains an enviable position of being subject to *real* defenses of any party to the instrument but only subject to the *personal* defenses of those with whom he has "dealt."<sup>17</sup> Because of this special immunity to personal defenses<sup>18</sup> such as failure of consideration, fraud in the inducement, or failure of a condition precedent, a holder who attains the holder in due course status is popularly viewed as a "Super-plaintiff"<sup>19</sup> in *most* actions to enforce another's ob-

good faith, without notice of a claim or defense.

- (1) A holder in due course is a holder who takes the instrument
  - (a) for value; and
  - (b) in good faith; and
  - (c) 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.
- (2) A payee may be a holder in due course.
- (3) A holder does not become holder in due course of an instrument:
  - (a) by purchase of it at judicial sale or by taking it under legal process; or
  - (b) by acquiring it in taking over an estate; or
  - (c) by purchasing it as part of a bulk transaction not in regular course of business of the transferor.
- (4) A purchaser of a limited interest can be a holder in due course only to the extent of the interest purchased.

U.C.C., *supra* note 4, at § 3-302.

13. *E.g.*, *Davis v. National City Bank of Rome*, 167 S.E. 191 (Ga. Ct. App. 1932); *Builders Lime & Cement Co. v. Weimer*, 151 N.W. 100, 102 (Iowa 1915); *St. Charles Sav. Bank v. Edwards*, 147 S.W. 978, 980 (Mo. 1912). *See generally* W. BRITTON, *supra* note 5, at 308-10, § 122, for a discussion of the rationale for holding that a payee cannot be a holder in due course.

14. *E.g.*, *Ex parte Goldberg*, 67 So. 839, 841 (Ala. 1914); *Boston Steel & I. Co. v. Steuer*, 66 N.E. 646, 648 (Mass. 1903); *Johnston v. Knipe*, 103 A. 957, 958 (Pa. 1918).

15. *See supra* note 5 for the definition of a remitter.

16. *See Vander Ploeg v. Van Zuuk*, 112 N.W. 807 (Iowa 1901) (distinguishing a payee who receives a draft from one who purchases it from the drawer or maker and a payee to whom the draft is initially issued by the drawer or maker on the instrument); W. BRITTON, *supra* note 5, at 315-18; Aigler, *Payees as Holders in Due Course*, 36 YALE L.J. 608 (1927).

17. "To the extent that a holder is a holder in due course he takes the instrument free from all defenses of any party to the instrument with whom the holder has not dealt . . ." U.C.C., *supra* note 4, at § 3-305(2). *See infra* note 33 for the complete text of U.C.C. § 3-305.

18. For a catalogue of "blessings which flow so bounteously for the holder in due course" see V. COUNTRYMAN, A. KAUFMAN & Z. WISEMAN, *COMMERCIAL LAW CASES AND MATERIALS* 464-65 (2d ed. 1982).

19. *See, e.g.*, *New Hampshire Insurance Co. v. Bank of Southwest*, 584 S.W.2d 560, 562 n.2 (Tex. Ct. App. 1979); D. WHALEY, *PROBLEMS AND MATERIALS ON NEGOTIABLE INSTRUMENTS* 4 n.2 (2d ed. 1988). The term was coined by J. White and R. Summers. J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM*

ligation to pay a negotiable instrument. The U.C.C. drafters sought to clarify the conflict in prior case law on a payee's right to holder in due course status by expressly providing that a payee may be a holder in due course<sup>20</sup> even though an agent or intermediary engaged in some wrongdoing during the transaction.<sup>21</sup> Resolving the issue of a payee's right to holder in due course status while granting an obligor the right to raise personal defenses against those with whom he or she has dealt, *the drafters* did not expressly address the more difficult question. Is a payee who otherwise satisfies the requirements for holder in due course<sup>22</sup> status subject to defenses arising from the conduct of *its* agent<sup>23</sup> and, more importantly, the conduct of the obligor's agent?<sup>24</sup> For example:

Seller engages *A* as auctioneer to sell antiques. Seller authorizes *A* to describe the vintage and historical value of the goods. *A*, believing of the goods are early 1600 French, describes them as such without knowing that the pieces are excellent reproductions. Buyer delivers to *A* notes drawn payable to Seller. Seller takes the notes for value, in good faith and without notice of the misrepresentation by *A*. After delivery of the goods, Buyer asserts fraudulent misrepresentation and failure of consideration because of *A*'s erroneous description of the goods at the time of sale. Is Seller a holder in due course? Has seller "dealt with" Buyer? Is Seller subject to these defenses?<sup>25</sup>

At first blush, the significance of these issues is not obvious and an understanding of the complexity of agency law is essential to resolve them in light of section 3-302 and section 3-305(2).

In comment two to section 3-302, the drafters lists seven illustrative fact situations of payees who qualify as holders in due course even though some wrongdoing by another occurs in the transaction—as in

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COMMERCIAL CODE 613, at § 14-1 (2d ed. 1980) [hereinafter J. WHITE & R. SUMMERS 2d] (in recognition of the immunity granted a holder in due course from personal defenses of prior parties).

20. U.C.C., *supra* note 4, at § 3-302(2).

21. *See infra* note 26.

22. Historically, commentators and courts addressed a payee's vulnerability to an obligor's defense by merely asking is the payee a holder in due course. This Article assumes a payee who satisfies the requisites of § 3-302 is a holder in due course. However, following the analytical scheme of the U.C.C., a second issue must be answered: has a payee, who is a holder in due course, "dealt with" the obligor. If yes, the payee who is a holder in due course is subject to the obligor's personal defenses. *See, e.g., Britton, The Payee as a Holder in Due Course*, 1 U. CHI. L. REV. 728, 736 (1934); *Hall v. Westmoreland, Hall & Bryan*, 182 S.E.2d 539, 541 (Ga. Ct. App. 1971) (discussing the appropriate analysis under the U.C.C.).

23. *See infra* discussion Part III and Case Six at note 175.

24. If the payee has notice of an agent's lack of authority or lacks a reasonable belief that the agent is authorized, payee will not be a holder in due course. U.C.C., *supra* note 4, at § 3-302(1)(c). Payee will have notice of a defense.

25. *See infra* Case six at note 175 and notes 175-200.

the example above.<sup>26</sup> Although recognizing that one may achieve holder in due course status as a payee and still be subject to personal defenses for having "dealt with" the obligor,<sup>27</sup> several important commentators state that the payees in those hypothetical situations presented by the drafters in comment two not only have the status of a holder in due course, but are also persons who have *not* "dealt with" the drawer or maker.<sup>28</sup> These payees are therefore not subject to the

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26. In the following cases, among others, the payee is a holder in due course:

a. A remitter [one who purchases or borrows an instrument with consent and is neither the payee nor the obligor on the instrument], purchasing goods from *P*, obtains a bank draft payable to *P* and forwards it to *P*, who takes it for value, in good faith and without notice as required by this section.

b. The remitter buys the bank draft payable to *P*, but it is forwarded by the bank directly to *P*, who takes it in good faith and without notice in payment of the remitter's obligation to him.

c. *A* and *B* sign a note as comakers. *A* induces *B* to sign by fraud, and without authority from *B* delivers the note to *P*, who takes it for value, in good faith and without notice.

d. *A* defrauds the maker into signing an instrument payable to *P*. *P* pays *A* for it in good faith and without notice, and the maker delivers the instrument directly to *P*.

e. *D* draws a check payable to *P* and gives it to his agent to be delivered to *P* in payment of *D*'s debt. The agent delivers it to *P*, who takes it in good faith and without notice in payment of the agent's debt to *P*. But as to this case see § 3-304(2), which may apply.

f. *D* draws a check payable to *P* but blank as to the amount, and gives it to his agent to be delivered to *P*. The agent fills in the check with an excessive amount, and *P* takes it for value, in good faith and without notice.

g. *D* draws a check blank as to the name of the payee, and gives it to his agent to be filled in with the name of *A* and delivered to *A*. The agent fills in the name of *P*, and *P* takes the check in good faith, for value and without notice.

U.C.C., *supra* note 4, at comment 2 § 3-302 (emphasis added).

27. See, e.g., E. FARNSWORTH, *CASES AND MATERIAL ON COMMERCIAL PAPER* 212 (3d ed. 1984); 4 W. HAWKLAND & L. LAWRENCE, *UNIFORM COMMERCIAL CODE SERIES* § 3-302:04, at 376-77 (1984); Farnsworth, *A General Survey of Article 3 and An Examination of Two Aspects of Codification*, 44 *TEX. L. REV.* 645, 651 (1966); J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 14-7, at 636 (3d ed. 1988) [hereinafter J. WHITE & R. SUMMERS 3d]. However, a student work, Note, *The Concept of Holder in Due Course in Article III of the Uniform Commercial Code*, 68 *COLUM. L. REV.* 1573, 1578 (1968), suggests that the payee's status as a holder in due course should rest on whether the payee took the instrument as a promisee or as a purchaser from a third party. The student argues that one who takes as a promisee should be denied freedom from personal defenses because of the payee's involvement in the underlying transaction and denied holder in due course status. Similarly, another often cited commentator states that for practical purposes, a payee who has direct dealing with an obligor will not achieve holder in due course status. See 5 R. ANDERSON, *ANDERSON ON THE UNIFORM COMMERCIAL CODE* § 3-302:38 (3d ed. 1984).

28. E. FARNSWORTH, *CASES AND MATERIALS ON COMMERCIAL PAPER* 212 (3d ed. 1984); J. WHITE & R. SUMMERS 2d, *supra* note 19, at 568, § 14-7; J. WHITE & R.

obligor's personal defenses that might otherwise result from the wrongful conduct of the agent or intermediary. Several cases reach a result that is contrary to this view.<sup>29</sup>

This Article suggests that the proper analysis for implementing the drafters' intent and for determining if a payee is subject to personal defenses requires resolution of the following questions: (1) Is payee a holder in due course pursuant to section 3-302—including addressing the issue of payee's notice of an agent's lack of authority; and, if the answer is "yes," (2) Has payee dealt with the obligor through a representative who exercised actual or apparent authority or inherent power? This Article addresses the issue of an obligor's right to raise personal defenses by focusing on relevant rules of agency law, pursuant to U.C.C. section 1-103, and the public policies underlying article three. This Article demonstrates that even in fact patterns similar to those included by the drafters in comment two to section 3-302, a payee who is a holder in due course may have "dealt with" the obligor and, therefore, will be subject to the obligor's personal defenses.

Neither the similarity to the hypothetical in comment two to section 3-302 nor a payee's actual distance from, or contact with, the underlying transaction is relevant in determining if the parties have "dealt with" one another. Rather, an agent's authority to act governs whether the payee has "dealt with" the obligor. This approach is consistent with the express language of the U.C.C. To automatically insulate a payee who transacts with or through an agent from all personal defenses, as these commentators suggest, grants the principal/payee a privilege that payees directly dealing with primary obligors do not receive. This places an unreasonable and unjustifiable burden on enterprises or other obligors who use agents, by limiting the defenses otherwise available in transactions consummated without the use of agents, and yields inconsistent results in transactions which are substantially similar. The rules of agency law must be used to answer the "dealt with" question.<sup>30</sup>

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SUMMERS 3d, *supra* note 27, at 636, § 14-7; Note, *supra* note 27, at 1578 n. 44 (1968). See also *Saale v. Interstate Steel Co.*, 275 N.Y.S.2d 532, 535 (App. Div. 1966), *aff'd* 281 N.Y.S.2d 340 (1967) (court notes similarity to comment 2 hypothetical); *Village Motors, Inc. v. American Fed. Sav. & Loan*, 345 S.E.2d 288, 290 (Va. 1986). *But see* CONCLUSION *infra*.

29. *Travelers Indemn. Co. v. American Express Co.*, 559 F. Supp. 452, 453 (S.D.N.Y. 1983) (payee who is a holder in due course is subject to the defenses of those with whom it has dealt) (see discussion, *infra* at note 172, of the court's misconstruction of the scope of the "dealt with" requirement); *Carolina First Nat'l v. Douglas Gallery of Homes*, 314 S.E.2d 801, 804 (N.C. App. 1984); *Lucas v. Whiteley*, 550 S.W.2d 767, 769 (Tex. Civ. App. 1977).

30. U.C.C., *supra* note 4, at § 1-103; see generally Summers, *General Equitable Principles Under Section 1-103 of the Uniform Commercial Code*, 72 Nw. U. L. REV. 906, 936-42 (1978).

This approach also prevents, as some have suggested,<sup>31</sup> denial of holder in due course status to a payee who satisfies the requirement of section 3-302 but has contact with the transaction without notice of a defense. To deprive a payee who satisfies section 3-302 of holder in due course status because he or she "dealt with" the obligor through a representative or agent unfairly deprives a payee of other rights to which he may be entitled. Examples of these rights include the right to raise the obligor's substantial negligence which precludes the obligor from asserting an unauthorized signature or alteration, a protection accorded holders in due course in section 3-406, or the right to assert finality of payment under section 3-418.<sup>32</sup>

Finally, this Article is organized into three parts. First, the Article reviews the test applied by the courts for determining whether primary parties have "dealt with" one another. Second, the Article identifies those underlying agency principles which bear upon the "dealt with" requirement when either party is represented in a transaction by an agent. Third, the relevant agency principles are then applied to the illustrations included by the drafters in comment two to U.C.C., section 3-302. These applications demonstrate that the illustrations are, as stated by the drafters, examples of payees who are holders in due course, but this does not exclude the possibility that the payees may have "dealt with" the obligor.

#### I. "DEALT WITH:" NON-AGENCY SETTING

Section 3-305(2) is a limitation on the broad immunity granted a holder in due course from claims and defenses under section 3-305(1).<sup>33</sup> Section 3-305(2) subjects a holder in due course to the personal defenses<sup>34</sup> of only those with whom he has dealt. This limitation

31. See Note, *supra* note 27.

32. 4 W. HAWKLAND & L. LAWRENCE, UNIFORM COMMERCIAL CODE SERIES 377, at § 3-302:04 (1984).

33. To the extent that a holder is a holder in due course he takes the instrument free from

- (1) all claims to it on the part of any person; and
- (2) all defenses of any party to the instrument with whom the holder has not dealt except
  - (a) infancy, to the extent that it is a defense to a simple contract; and
  - (b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
  - (c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its proceedings; and
  - (d) discharge in insolvency proceedings; and
  - (e) any other discharge of which the holder has notice when he takes the instrument.

U.C.C., *supra* note 4, at § 3-305.

34. Historically, the law recognized three kinds of rights in an instrument: claims



on the holder in due course's special immunity first appeared in the 1952 draft of section 3-305<sup>35</sup> without comment from the drafters regarding its inclusion. Furthermore, "dealt with," and a related concept,

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or equities of ownership; legal title of legal ownership; and equities of defense. Claims, or rights of restitution arising when possession of an instrument is voluntarily and intentionally transferred to another, were distinguished from equities of defense, a "right to resist" payment when liability on an instrument was established. While claims and legal title were both defined as property rights, legal title rested in the one to whom the promise to pay ran. Legal title was distinct from a claim, which is a right to reclaim possession when legal title had been voluntarily transferred or surrendered to another. W. BRITTON, *HANDBOOK OF THE LAW OF BILLS AND NOTES* 453, at §§ 155-56 (2d ed. 1961). See also Blum, *The Use of the Jus Tertii Defense by an Obligor on a Negotiable Instrument*, 84 COMMON L.J. 131, 131 (1979); Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104, 1109 (1918); Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1066 (1954); Note, *Blocking Payment of a Certified, Cashier's or Bank Check*, 73 MICH. L. REV. 424 (1974) (this note fails to distinguish claims and legal title); Comment, *Adverse Claims & The Consumer—Is Stop Payment Protection Available?*, 67 NW. U.L. REV. 915, 919-20 (1973). These distinctions are now blurred in the U.C.C.

Although the drafters distinguish claims from defenses in § 3-305, the distinction has no practical significance in litigation between immediate parties. "Claim" as it is broadly defined in U.C.C., *supra* note 4, at comment two to § 3-305 becomes generic meaning any right whether based on legal title, equities of ownership, right of avoidance, or right to resist an established liability. U.C.C., *supra* note 4, at comment 2 § 3-306 supports this conclusion. Thus, the substantive distinctions between claims and defenses are no longer delineated. Some argue that the distinction between the two is unjustified and others argue that the distinction is unintended. See, e.g., Blum, 84 COMMON L.J. at 134 (distinction between claim and defenses not intended to have significance); Note at 433 (no sound reason for distinction between claims and defenses).

Furthermore, a distinction between claims and defenses does not result from the manner either is procedurally asserted. A holder in due course takes subject to the personal defenses of one with whom he or she has dealt. U.C.C., *supra* note 4, at § 3-305(2). Pursuant to rule 8 of the Federal Rules of Civil Procedure, there exists a right to resist an obligation to pay even if the defense or facts asserted permit affirmative relief. FED. R. CIV. PROC. 8(c) (affirmative defenses include any matter constituting an avoidance). See, e.g., *Maryland Cas. Co. v. Employers Mut. Liab. Ins. Co.*, 208 F.2d 731 (2d Cir. 1953) (circuity of action formerly available only by bill of equity constitutes an affirmative defense).

Moreover, a transferor who "dealt with" the holder in due course may bring an action for replevin or rescission, rescind the negotiation, and cancel the instrument pursuant to § 3-207(2). Thus, as between the holder in due course and the obligor with whom he or she has dealt, the holder in due course, as plaintiff or defendant, must respond to the rights held by the obligor whether denominated a claim or defense.

35. See UNIFORM COMMERCIAL CODE § 3-305(2) (Proposed Official Draft 1951); UNIFORM COMMERCIAL CODE § 3-305(2) (Proposed Official Draft 1952); 1950 HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS ON THE ANNUAL CONFERENCE MEETING IN ITS 59TH YEAR; 1951 HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS OF THE ANNUAL CONFERENCE MEETING IN ITS 60TH YEAR; 1952 HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS OF THE ANNUAL CONFERENCE MEETING IN ITS 61ST YEAR. See generally Schnader, *A Short History of the Preparation and Enactment of the Uniform Commercial Code*, 22 U. MIAMI L. REV. 1 (1967).

“subsequent holder in due course,”<sup>36</sup> is not defined in the U.C.C.

However, courts have encountered little difficulty in determining if parties have “dealt with” one another when the parties transact without the assistance of agents. A holder in due course is deemed to have “dealt with” the obligor when the holder in due course has direct dealings with the obligor in the transaction in which the negotiable instrument is issued or negotiated to the holder in due course;<sup>37</sup> or if the holder in due course has been “so involved in the disputed transaction”<sup>38</sup> that he or she does not take free of defenses. *Village Motors, Inc. v. American Federal Savings & Loan*,<sup>39</sup> and *Wilmington Trust Co. v. Delaware Auto Sales*,<sup>40</sup> illustrate what might be called a “contact” test applied by the courts to determine if one is “sufficiently close to the transaction”<sup>41</sup> to have “dealt with” the obligor.

In *Village Motors*, Dealer agreed to sell a used car for a specified sum payable only by bank check.<sup>42</sup> After Dealer received and deposited the bank check drawn by Purchaser’s Savings & Loan on its account with a commercial bank, Purchaser became dissatisfied with the car and returned it to Dealer. Purchaser also requested the Savings & Loan to stop payment on the check delivered to the Dealer. Complying with its customer’s request, the Savings & Loan issued a stop payment order to its bank. The bank complied.

In a suit against the Savings & Loan, Dealer argued that he was a holder in due course and not subject to any defenses the Savings & Loan might raise. The Savings & Loan asserted the Dealer “dealt with” it by requiring Purchaser to procure and deliver a bank check as a condition for obtaining title. Apparently, there were neither negotia-

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36. Any holder in due course who takes an instrument without having “dealt with” the obligor is a subsequent holder in due course. See *Synder v. Town Hill Motor, Inc.*, 165 A.2d 293, 295 (Pa. Super. Ct. 1960) (defendant a subsequent holder in due course, even though prior holder on a constructive delivery was not a holder in due course). U.C.C., *supra* note 4, at §§ 3-208, 3-407(2) & (3), 3-602 are provisions which use the term “subsequent holder in due course” and identify rights of one attaining such a status.

37. *Home Center Supply, Inc., v. Certaineed Corp.* 476 A.2d 724 (Md. App. 1984); *Casanova Club v. Bisharat*, 458 A.2d 1 (Conn. 1983); *Wilmington Trust Co. v. Delaware Auto Sales*, 271 A.2d 41 (Del. 1970); *Bucci v. Paulick*, 419 A.2d 1255 (Pa. Super. Ct. 1980).

38. *Village Motors v. American Fed. Sav. & Loan*, 345 S.E.2d 288, 290 (Va. 1986); *Chicago Title and Trust Co. v. Walsh*, 340 N.E.2d 106, 112 (Ill. App. Ct. 1975).

39. 345 S.E.2d 288 (Va. 1986).

40. 271 A.2d 41 (Del. 1970).

41. Note, *supra* note 27, at 1578.

42. A bank check is a check or draft drawn by a bank, an individual or organization engaged in the business of banking, on its account at another bank and not itself. H. BAILEY, *BRADY ON BANK CHECKS* ¶ 1.18 (6th ed. 1979); see also U.C.C., *supra* note 4, at §§ 3-104(2)(a)(b), 1-201(4)(30).

tions,<sup>43</sup> nor business dealings,<sup>44</sup> not even a communication between Dealer and Savings & Loan.<sup>45</sup> The Virginia Supreme Court, noting the absence of "direct interchange,"<sup>46</sup> correctly held that the Savings & Loan had failed to establish, in the absence of an agency relationship, that it had "dealt with" the Dealer.<sup>47</sup>

In so holding, the Virginia Supreme Court distinguished *Wilmington Trust Co.*<sup>48</sup> on the basis of what it characterized as "direct contact" between the holder and the obligor in the earlier case.<sup>49</sup> In *Wilmington Trust Co.*, Dealer exchanged Purchaser's personal check, received as consideration for a car, at Purchaser's bank, the Drawee bank, for a treasurer's or cashier's check drawn by the Drawee bank on itself in the same amount.<sup>50</sup> Dealer made the exchange shortly after Purchaser issued a stop payment order on his personal check at another branch of Drawee bank.<sup>51</sup>

Later, when Dealer presented the treasurer's check for payment, the item<sup>52</sup> was cancelled.<sup>53</sup> Dealer sued Drawee on the treasurer's check and contended he was a holder in due course. Although held to be a holder in due course, Dealer was also held to have "dealt with" Drawee and was, therefore, subject to Drawee's defense of failure of consideration and mistake. The process of exchanging the Purchaser's personal check for the Drawee's treasurer's check was "direct contact"<sup>54</sup> between immediate parties<sup>55</sup> which satisfied the "dealt with" requirement.<sup>56</sup>

In *Wilmington*, Drawee's defense of failure of consideration arose from conduct that occurred in the second of two transactions and related to the bargain between Drawee and Dealer. The defense did not arise from the initial bargain in which the car was exchanged by Dealer for the Purchaser's personal check, as in *Village Motors*. The

43. See, e.g., *Home Center Supply, Inc. v. Certainteed Corp.*, 476 A.2d 724 (Md. App. 1984).

44. See, e.g., cases *supra* note 38.

45. See, e.g., *Chicago Title & Trust Co. v. Walsh*, 340 N.E.2d 106 (Ill. App. Ct. 1975) (holder's mere communication with escrow agent of account numbers for which payment to be received and payment dates insufficient for establishing that holder dealt with escrow agent). Mere communication, however, should be insufficient to establish direct dealings between the parties to the lawsuit.

46. *Village Motors*, 345 S.E.2d at 290.

47. *Id.* at 291.

48. 271 A.2d 41 (Del. 1970).

49. *Village Motors*, 345 S.E.2d at 291.

50. *Wilmington*, 271 A.2d at 41.

51. *Id.*

52. "'Item' means any instrument for the payment of money even though it is not negotiable but does not include money." U.C.C., *supra* note 4, at § 4-104(g).

53. 271 A.2d at 42.

54. *Village Motors*, 345 S.E.2d at 291.

55. *Wilmington*, 271 A.2d at 42.

56. *Id.*

check given to Drawee in the second transaction by Dealer as consideration for the treasurer's check was not paid. The consideration received for the treasurer's check failed. If the stop order was timely received, Purchaser's stop order had priority over Purchaser's order to pay.<sup>57</sup> Apparently acting on the premise that the stop order was timely received,<sup>58</sup> the *Wilmington* court concluded that Drawee, not having received consideration for its treasurer's check, had properly refused to honor it.<sup>59</sup>

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57. U.C.C., *supra* note 4, at §§ 4-303, 4-403.

58. The court made two assumptions to reach this conclusion: (1) the stop order had priority over the item; and (2) Purchaser's check was *not* finally paid when the Bank issued the treasurer's check. First, the court must have concluded that the bank had receipt of the Purchaser's stop order plus a reasonable time to act before the Bank issued the treasurer's check in exchange for the Purchaser's check. *Siniscalchi v. Valley Bank of New York*, 359 N.Y.S.2d 173 (Dist. Ct. 1974) (receipt plus a lapse of reasonable time is necessary before a stop order is effective); U.C.C., *supra* note 4, at § 4-303. Based on the reported facts, this conclusion appear erroneous. Purchaser called the Seaford branch early to stop payment, the stop payment order "was noted in the Wilmington office at 8:35 a.m." *Wilmington*, 271 A.2d at 41. Within 25 to 55 minutes of Purchaser's call to the Seaford branch, Dealer exchanged the personal check for the treasurer's check. The court noted that a stop order takes one to two hours to process. *Wilmington*, 271 A.2d at 42. If this one to two hour time period was within the customary time frame in the industry and locality, the Bank did not have a reasonable time to act between receipt of the order and issuance of the treasurer's check. Without the lapse of a reasonable time to act (one to two hours), the stop order arrived too late to be honored. There was at the very least a question of fact on whether the stop order was timely received and, therefore, effective.

If an order arrives after an item is paid, it arrives too late. The customer's check is then properly payable and the customer's account may be charged for the item received and paid before an effective stop order. If the stop order is timely—reasonable time to act—the customer's check received thereafter is not properly payable and the customer's account may not be charged. Assuming the stop order in *Wilmington* was not effective at 8:35 a.m., the court's second assumption that the customer's check was not properly payable is also incorrect. Most authorities hold that issuing a cashier's or treasurer's check in exchange for a depositor's check is equivalent to paying the item in cash. *Hill v. Mercantile First Nat'l Bank*, 693 S.W.2d 285, 290 (Mo. App. 1985). When the Bank issued its treasurer's check in exchange for the Purchaser's check, the Bank *finally paid* the Purchaser's check. At that point, the Purchaser's account could be properly charged. The Bank's failure to charge Purchaser's account should not be recognized as a failure of a consideration defense. The Bank had a right to charge the account and failed to exercise that right.

59. While this outcome is supported by the U.C.C.'s scheme, some courts follow the pre-code treatment of cashier's checks as cash or instruments accepted when issued and not subject to dishonor. This second view requires a bank to honor its obligation to pay regardless of the factual setting in which the instrument is issued. One commentator supports this "cash-like" approach and justifies the outcome on what is termed a "nonliteralist" interpretation of the "dealt with" language of U.C.C., *supra* note 4, at § 3-305(2). An interpretation that requires denial of holder in due course status and subjects a holder to personal defense if the holder's conduct is responsible for the breakdown of the transaction in which the instrument was issued. *See* R. HILLMAN, J. McDONNELL & S. NICKLES, *COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE* ¶¶ 11.01[2][b], 11.03[4][c] (1985). *See also* *Munson v. American*

Thus, "dealt with" should pose little difficulty for courts in a transaction between primary parties. If the facts do not establish "direct dealing" or contact more than merely communicating data extraneous to the terms of the instrument, the holder in due course is not subject to the defense sought to be raised. However, this *contact test* becomes an ineffective tool if either or both primary parties to a transaction are represented by agents.

## II. HE WHO ACTS THROUGH ANOTHER, ACTS HIMSELF<sup>60</sup>

Determining if the payee has "dealt with" the obligor becomes a more difficult question if representatives or agents are used by either party.<sup>61</sup> Scrutinizing the transaction for direct dealings and contact between the principals will usually prove fruitless. The negotiating and dealing will generally be accomplished by representatives. Some other test must be employed in these circumstances.

It is generally accepted that one who acts through an agent acts himself.<sup>62</sup> While one may purport to act for another, or a third party may mistakenly assume one acts for another, the law of agency which supplements article three provides guidelines for determining if one is indeed acting for another.<sup>63</sup> A brief summary of agency law is essential to resolve the issue of direct dealing between a payee and an obligor if either or both are represented by an agent.

Most recognized authorities agree that agency is a consensual relationship that results from an objective manifestation of consent that another, subject to the consenting party's control, will act on behalf of

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Nat'l Bank & Trust Co. of Chicago, 484 F.2d 620, 673 (7th Cir. 1973); *Able & Assoc. v. Orchard Hills Farms, Inc.*, 395 N.E.2d 1138, 1140 (Ill. App. Ct. 1979).

However, those courts recognizing a bank's right to dishonor its own cashier's check as in *Wilmington* do so in three cases: (1) the instrument is held by one who is not a holder in due course under U.C.C. § 3-306 and the bank is permitted to raise its defenses; (2) the instrument is held by a payee who may be a holder in due course but the bank issued the instrument for its own purpose, thus, "dealing with" the payee; or (3) the instrument is held by a payee who acquired it for his purposes, again the "dealt with" requirement is satisfied. Any public policy interest in upholding the public's expectation of the "cash-like" nature of the instrument is not weakened in these cases given the absence of an innocent third party payee who obtains the instrument from a remitter. *See, e.g.*, *TPO Inc. v. FDIC*, 487 F.2d 131 (3d Cir. 1973). *See also Farmers & Merchants State Bank v. Western Bank*, 841 F.2d 1433, 1438-41 (9th Cir. 1988) (§ 4-303 inapplicable to a bank's right to raise its defenses to a cashier's check); *Rezapolvi v. First Nat'l Bank of Maryland*, 459 A.2d 183, 188-89 (Md. 1983) (bank may raise its defenses to its cashier's check).

60. A Latin maxim, *Qui Facit Per Alium Facit Per Se*, states the acts of an agent are the acts of the principal. BLACK'S, *supra* note 3, at 1124.

61. *See, e.g.*, *Saale v. Interstate Steel Co.*, 275 N.Y.S.2d 532 (App. Div. 1966), *aff'd*, 281 N.Y.S.2d 340 (1970).

62. RESTATEMENT, *supra* note 2, at § 12 comment a; W. SELL, *SELL ON AGENCY* § 2 (1975).

63. H. REUSCHLEIN & W. GREGORY, *supra* note 2, at § 1.

the consenting party.<sup>64</sup> This objective manifestation of consent may be made to the individual who will act on behalf of the consenting party,<sup>65</sup> the agent, or a third party<sup>66</sup> with or without the agent's knowledge of the consent given or the agent's assent to the relationship created.<sup>67</sup> The objective manifestation bestows upon the agent the power or the "ability to effect changes in the legal relations . . . between third parties and his principal."<sup>68</sup>

Three types of power may be bestowed upon an agent: (1) expressly or impliedly authorized power;<sup>69</sup> (2) apparently authorized power;<sup>70</sup> and (3) inherent power.<sup>71</sup> An agent's ability to affect the principal's legal relationship depends on the manifestation made,<sup>72</sup> if any, and to whom it is made.<sup>73</sup>

64. See, e.g., RESTATEMENT, *supra* note 2, at §§ 1, 12, comment c; H. REUSCHLEIN & W. GREGORY, *supra* note 2, at § 2; W. SELL, *supra* note 60, at § 2; see generally Conant, *The Objective Theory of Agency*, 47 NEB. L. REV. 678, 682 (1968); Fishman, *Inherent Agency Power—Should Enterprise Liability Apply to Agent's Unauthorized Contract?*, 19 RUTGERS L.J. 1, 2 (1987); Hetherington, *Trends in Enterprise Liability Law and the Unauthorized Agent*, 19 STAN. L. REV. 76 (1966); Seavey, *supra* note 2, at 859-64.

65. *Arrington & Blount Ford, Inc. v. Jinks*, 270 S.E.2d 27, 29 (Ga. Ct. App. 1980) (purported agent's conduct and principal's failure to object yield agency by implication); *Dillon v. City of Davenport*, 366 N.W.2d 918, 923-25 (Iowa 1985) (attorney given express authority). See *infra* at notes 46-51 and accompanying text.

66. *Harris v. Knutson*, 151 N.W.2d 654, 658 (Wis. 1967) (acts by insurer justify reasonable belief that agent is authorized).

67. *Birmingham New Co. v. Birmingham Printing Co.*, 104 So. 506, 508 (Ala. 1925) (stating this rule); *Hearn v. Louisville & N.R. Co.*, 60 So. 600, 601 (Ala. Civ. App. 1912) (consent made to third party with agent's knowledge.); *W. Sell, supra* note 62, at § 5.

68. *W. SELL, supra* note 62, at § 2. See also RESTATEMENT, *supra* note 2, at §§ 6, 12.

69. *Liberty Mut. Ins. Co. v. Enjay Chem. Co. (now Exxon Corp.)*, 316 A.2d 219, 222 (Del. Super. 1974) (agent's receiving and endorsing checks for nine years without principal's objection justify jury's finding of actual authority); *Dillon v. City of Davenport*, 366 N.W.2d at 923-25; *Gardner v. Rensmeyer*, 557 P.2d 1258, 1261 (Kan. 1976) (actual authority implied from principal's conduct, statements, and circumstances).

70. *William B. Tanner Co., Inc. v. WIOO, Inc.*, 528 F.2d 262, 266 (3d Cir. 1975) (applying Pennsylvania law, principal's conduct supports finding apparent authority); *Zimmerman v. Hogg & Allen, Professional Ass'n*, 209 S.E.2d 795, 799-80 (N.C. 1974) (officer-director of professional association engaged in the practice of labor law may have apparent authority to buy and sell securities).

71. *Ebasco Services, Inc. v. Pennsylvania Power & Light Co.*, 460 F. Supp. 163, 203 (E.D. Pa. 1978) (agent engaged in conduct consistent with other turnkey contractor in the trade).

72. See *Julien J. Studley, Inc. v. Gulf Oil Corp.*, 386 F.2d 161 (2d Cir. 1967); *Tennessee Gas & Transmission Co. v. Cooke*, 206 S.W.2d 491, 494 (Ky. 1947); *Heshion Motors v. Western Intern. Hotels*, 600 S.W.2d 526, 531-35 (Mo. App. 1980); *Zimmerman*, 209 S.E.2d at 800-04.

73. See *Senor v. Bangor Mills, Inc.*, 211 F.2d 685, 689 (3d Cir. 1954); *Thalin v. Friden Calculating Machines Co., Inc.*, 153 N.E.2d 658, 660 (Mass. 1958) (purported principal's proof of the franchise agreement with purported agent best evidence of rela-

### A. *Express and Implied Authority*

For express authority, a principal may create an agency relationship by words or conduct that reasonably leads the agent to believe she may act on behalf of the principal;<sup>74</sup> oral or written statements;<sup>75</sup> failure to object to the agent's conduct;<sup>76</sup> conduct directed to and which reaches the agent;<sup>77</sup> or words or conduct "intended to cause the agent to believe that he is authorized or . . . [that the] Principal should realize will cause such belief," may create express authority to bind the principal.<sup>78</sup> However, a purported agent's unreasonable belief that he may act for another is insufficient.

Implied authority parallels implied in-fact contracts, consent based on actions, conduct, or circumstances including acquiescence directed to the purported agent. Implied authority also includes that power which is necessary to accomplish the tasks, purposes, and power expressly given.<sup>79</sup>

### B. *Apparent Authority*

Because the hypothetical situations in comment two to section 3-302 involve some wrongful act by an agent or intermediary contrary to express authority given by the principal, the rules for determining whether one has apparent authority or inherent power<sup>80</sup> to act for another are of greater importance than express or implied authority. Like express authority, apparent authority—the appearance of authority to

relationship and lack of authority to extend life-time employment to plaintiff); *Kasselder v. Kapperman*, 316 N.W.2d 628 (S.D. 1982) (party asserting agency relationship has the burden of proof; agent liable for repair cost in excess of actual authority, no manifestations by principal to plaintiff to establish apparent authority for excess).

74. *W. SELL*, *supra* note 62, at § 34. *See also Lycoming Trust v. Allen*, 156 A. 707, 709 (Pa. Super. Ct. 1931) (trial court's exclusion of plaintiffs proof that treasurer had actual authority held as error; treasurer's indorsement of commercial paper for conducting business was corporation's custom).

75. *Rezapolvi v. First Nat'l Bank*, 459 A.2d 183, 190 (Md. 1983) (employee's signature on check was an authorized signature when directed to sign by company president even though drawer bank not notified). *See also Bergstrom v. Sears, Roebuck and Co.*, 532 F. Supp. 923, 933 (D. Minn. 1982); *Walden v. Koehler*, 349 P.2d 379, 380 (Colo. 1960); *Dillon v. City of Davenport*, 366 N.W.2d 918, 924 (Iowa 1985).

76. *RESTATEMENT*, *supra* note 2, at §§ 26 comment d. *See also Arrington & Blunt Ford, Inc. v. Jinks*, 270 S.E.2d 27 (Ga. Ct. App. 1980).

77. *W. SELL*, *supra* note 62, at § 34.

78. *RESTATEMENT*, *supra* note 2, at § 26 comment b. *See Arkansas Valley Feed Mills, Inc. v. Fox De Luxe Foods, Inc.*, 171 F. Supp. 145, 157 (W.D. Ark. 1959) (actual authority created when board of directors relied on and acquiesced to officer's decisions); *Tomerlin v. Canadian Indem. Co.*, 394 P.2d 571, 575 (Cal. 1964) (insurer's silence after receipt of correspondence from its counsel sufficient to create reasonable belief of actual authority).

79. *See, e.g., Kirk v. Showeel, Fryer & Co., Inc.*, 120 A. 670, 671-72 (Pa. 1923).

80. *See infra* notes 104-32 and accompanying text.

act for another—is based on some manifestation by the principal. The manifestations must originate with the principal, but unlike those creating express authority, are communicated to or directed to a third party and not the purported agent.<sup>81</sup>

Just as an offeree must know of the offeror's offer before an enforceable contract arises with an acceptance,<sup>82</sup> apparent authority requires that the third party know of the principal's manifestation, conduct, words, or appearance before an agent has apparent authority to bind the principal.<sup>83</sup> The principal's manifestation to the third party is the basis upon which the contractual relationship between the principal and the third party rests. Most authorities state that no change of position in reliance on the manifestation is needed to create apparent authority.<sup>84</sup> A principal may consent to another's acting on his or her behalf by words or conduct directed to or communicated to a third person who reasonably believes that the other is authorized.<sup>85</sup> However, the third person must have knowledge of the facts from which he infers that the purported agent is authorized.<sup>86</sup>

Consequently, this consent may result from advertisements or signs;<sup>87</sup> continuous employment of an agent;<sup>88</sup> authorized statements of authority made by the agent to the third party;<sup>89</sup> documents or other indicia of authority such as business cards, manuals, or letters given to the agent and shown or displayed by the agent to the third party;<sup>90</sup>

81. W. SELL, *supra* note 62, at § 35; *see generally* Rubenstein, *Apparent Authority: An Examination of a Legal Problem*, 44 A.B.A.J. 849 (1958).

82. *Broadnax v. Ledbetter*, 99 S.W. 1111 (Tex. 1907); RESTATEMENT (SECOND) OF CONTRACTS § 23 (1979).

83. RESTATEMENT, *supra* note 2, at § 8 comment d.

84. *Cook, Agency by Estoppel*, 5 COLUM. L. REV. 36 (1905) (discussing the contractual basis of apparent authority); RESTATEMENT *supra* note 2, at §§ 8 comments c, d; 8B; *Sell, supra* note 62, at § 5. *But see* *Beasley v. Kerr-McGee Chem. Corp.*, 257 S.E.2d 726, 728 (S.C. 1979) (change of position required for apparent authority).

85. RESTATEMENT, *supra* note 2, at §§ 8, 27; *Conant, supra* note 64, at 681-86; *Seavey, supra* note 2, at 872-76.

86. RESTATEMENT, *supra* note 2, at § 27 comment b. *See also* *Bolus v. United Penn. Bank*, 525 A.2d 1215, 1222 (Pa. Super. Ct. 1987).

87. *Boone v. General Shoe Corp.*, 242 S.W.2d 138, 142 (Ark. 1951) (owner operating dress shop in shared premises under one business name held responsible for debts of the other); *Campbell v. John Deere Plow Co.*, 172 P.2d 319, 320 (Okla. 1946) (dealer advertised as dealer of manufacturer and manufacturer's name prominently displayed). RESTATEMENT, *supra* note 2, at § 8 comment b.

88. *Record v. Wagner*, 128 A.2d 921, 923 (N.H. 1957) (former agent's continued occupancy of property and management of farm substantiate finding of apparent authority).

89. RESTATEMENT, *supra* note 2, at § 27 comment c.

90. RESTATEMENT, *supra* note 2, at § 27 comment a. *See also* *Bailey v. Ness*, 708 P.2d 900 (Idaho 1985) (summary judgment inappropriate; factual issue of apparent authority exists given purported agent's possession of indicia of authority); *Campbell*, 172 P.2d at 320.



prior dealings between the principal and the third party;<sup>91</sup> or placing a person in a position which carries generally recognized duties, coupled with a third party's knowledge of the appointment, which may give an agent apparent authority to perform acts ordinarily engaged in by one in such a position in the trade or industry in question.<sup>92</sup> This latter manifestation of apparent authority, placing one in a position which carries generally recognized duties, has been judicially extended to impose liability on principals for an agent's exercise of inherent power.<sup>93</sup>

At this juncture, it is important to distinguish apparent authority from estoppel, a tort law concept—"a form of deceit,"<sup>94</sup> which is often confused with apparent authority.<sup>95</sup> The two are distinguishable not only in their substantive requirements because of their different theoretical bases, one in contract and the other in tort,<sup>96</sup> but also in the legal effect of the parties' transaction.<sup>97</sup> Substantively, estoppel requires a change of position by an innocent third party in reliance on the belief that the purported agent is authorized.<sup>98</sup> The third party's erroneous belief that the agent is authorized may result from the purported principal's silence when the third party is acting, or the purported principal knows the third party may act on a belief that the agent is authorized,<sup>99</sup> or the third party's belief may result from the principal's care-

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91. *O'Day v. George Arakelian Farms, Inc.*, 540 P.2d 197, 198 (Ariz. App. 1975). A two-pronged test for determining apparent authority based on prior dealings requires that the prior dealings have: (1) a measure of similarity to the act in question and (2) a degree of repetitiveness. See *Lincoln Bank v. National Life Ins. Co.*, 476 F. Supp. 1118, 1120 (E.D. Pa. 1979) (applying Pennsylvania law); *Jennings v. Pittsburgh Mercantile Co.*, 202 A.2d 51, 54 (Pa. 1964); *Brientnall v. Peters*, 176 A. 240 (Pa. 1935); *Colonial Trust Co. v. Davis*, 118 A. 312 (Pa. 1922).

92. RESTATEMENT, *supra* note 2, at § 27 comment a; see *Bucher & Willis Consulting Engineers, Planners and Architects v. Smith*, 643 P.2d 1156 (1982), *aff'd*, 718 P.2d 309 (Kan. 1984) (appointing an attorney clothed him with apparent authority to obligate estate for routine services for estate administration); *Sauber v. Northland Insurance Co.*, 87 N.W.2d 591, 597 (Minn. 1958) (persons may rely on information given by employee authorized to answer business telephone); *Bolus v. United Penn. Bank*, 525 A.2d 1215 (Pa. 1987) (bank clothed officer with authority).

93. W. SEAVEY, *HANDBOOK OF THE LAW OF AGENCY* 105, at § 58 (1964); Conant, *supra* note 64 at 678, 686. See *infra* notes 104-32 and accompanying text for discussion of inherent power.

94. RESTATEMENT, *supra* note 2, at § 8 comment d; see also Conant, *supra* note 64, at 684.

95. W. SEAVEY, *supra* note 93, § 8E, at 14; Whelan & Dunigan, *Government Contracts: Apparent Authority and Estoppel*, 55 GEO. L.J. 830, 832 (1967).

96. Cook, *supra* note 84, at 46-47; Conant, *supra* note 64, at 683-86. Whelan & Dunigan, *supra* note 95, at 832 (1967).

97. RESTATEMENT, *supra* note 2, at § 8B comment b.

98. See *supra* note 84.

99. *Traylor v. Gray*, 547 S.W.2d 644, 652 (Tex. Ct. Civ. App. 1977) (buyer's agent, without actual authority, entered futures contract with seller without using indicia of authority and conduct consistent with prior dealings with seller on buyer's behalf; buyer's silence after notice of unauthorized contract between seller and agent held

less or intentional misstatements.<sup>100</sup>

The goal of estoppel is to prevent loss to an innocent third party who changes position as a result of some tortious dereliction of duty by the purporting principal by denying him or her the right to establish the absence of an agency relationship.<sup>101</sup> No contract arises between the third party and the purported principal.<sup>102</sup> Thus, the purported principal has no right to enforce any promise made by the third party.<sup>103</sup>

### C. *Inherent Agency Power*

In the absence of actual or apparent authority, a principal may be held responsible for unauthorized promises or disobedient acts of its general agent<sup>104</sup> under certain circumstances. If its general managers, or regular or long term employees, acting on behalf of their principal, engage in an act which usually accompanies or is incidental to authorized transactions performed by such agents in the relevant trade or industry,<sup>105</sup> the principal is liable. Inherent power may be exercised by the agent of a principal whose identity is disclosed,<sup>106</sup> partially disclosed<sup>107</sup> or totally disclosed.<sup>108</sup> Under article three, liability on a negotiable instrument is only imposed on principals who are disclosed or

the basis of estoppel given change of position of seller); RESTATEMENT, *supra* note 2, at § 8B(1)(b) comment c. *Cf.* West Penn Admin., Inc. v. Union Nat'l Bank of Pittsburgh, 335 A.2d 725, 735 (Pa. 1975) (payee/payor estopped from asserting unauthorized indorsements after paying prior instruments with forged indorsements).

100. RESTATEMENT, *supra* note 2, at § 8B(1)(a) comment b.

101. Hoddeson v. Koos Brothers, 135 A.2d 702, 707 (N.j. Super. A.D. 1957).

102. RESTATEMENT, *supra* note 2, at § 8B comment b; Conant, *supra* note 64, at 683-84.

103. RESTATEMENT, *supra* note 2, at § 8B comment b.

104. "A general agent is an agent authorized to conduct a series of transactions involving a continuity of service." RESTATEMENT, *supra* note 2, at § 3. Continuity of service without the need for "fresh authorization for each transaction" is the key factor in distinguishing a general agent from a special agent. RESTATEMENT, *supra* note 2, at § 3 comment a. *See also* Seavey, *Agency Powers*, 1 OKLA. L. REV. 3, 3-5 (1948). Columbia Broadcasting Sys. Inc. v. Stokely-Van Camp, Inc., 522 F.2d 369, 376 (2d Cir. 1975), the following factors were identified as helpful in distinguishing general and special agents: the situation of the parties; their relationship to one another; the business in which they are engaged; general usages of the business; the purported business methods of the principal; and the nature of the subject matter.

105. RESTATEMENT, *supra* note 2, at §§ 161, 194. *See generally* Columbia Broadcasting Sys. Inc. v. Stokely-Van Camp, Inc., 522 F.2d at 376; Lincoln Bank v. National Life Ins., Co., 476 F. Supp. 1118, 1122 (E.D. Pa. 1979); RESTATEMENT, *supra* note 2, at § 161 comments a, b; Mearns, *Vicarious Liability for Agency Contracts*, 48 VA. L. REV. 50 (1962).

106. RESTATEMENT, *supra* note 4, at *supra* note 2, at § 161.

107. *Id.*

108. RESTATEMENT, *supra* note 4, at *supra* note 2, at § 194.

partially disclosed.<sup>109</sup> Sections 3-401 and 3-404 limit liability on a negotiable instrument to one whose authorized signature appears on the instrument. Thus, an agent with actual or apparent authority or inherent power to sign negotiable instruments may sign the principal's name to the instrument.<sup>110</sup> Here the principal is disclosed.<sup>111</sup>

Partial disclosure occurs if either the principal's name or the agent's representative capacity is shown on the face of the instrument.<sup>112</sup> Between immediate parties, the payee and the obligor, liability may be imposed on a partially disclosed principal under section 3-403. Parol evidence is admissible to establish the intent of the payee and the agent to recognize the principal's liability if the agency relationship is partially disclosed.<sup>113</sup> Therefore, in the context of a negotiable instrument, the rules of inherent power for disclosed or partially disclosed principals are relevant.<sup>114</sup> Those for undisclosed principals are not relevant.

To establish an exercise of inherent power when the principal is disclosed or partially disclosed, a third party must be unaware of the absence of actual or apparent authority and reasonably believe the agent is authorized to act.<sup>115</sup> While most authorities limit inherent power liability to promises or acts that usually accompany or are incidental to authorized transactions,<sup>116</sup> at least one court has extended inherent power to those promises or acts which are dissimilar to those engaged in the trade if the injured party held a mistaken yet reasonable belief that the act or promise undertaken was part of the principal's enterprise or business.<sup>117</sup> Whether inherent power is an asserted basis of liability for promises or acts incidental to those authorized, those performed by agents similarly situated within the trade, or those inconsistent with trade custom, the court should require a third party to establish his or her reasonable belief that the purported agent was authorized to act for the principal. Requiring a reasonable belief of an agent's power to act results in a balance between: (1) extending a principal's liability to a point where conducting business becomes unduly

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109. U.C.C., *supra* note 4, at § 3-403.

110. U.C.C., *supra* note 4, at §§ 1-201(43), 3-401, 3-403.

111. RESTATEMENT, *supra* note 2, at § 4(1).

112. U.C.C., *supra* note 4, at § 3-403(2)(b); RESTATEMENT, *supra* note 2, at § 4(2).

113. U.C.C., *supra* note 4, at § 3-403(2)(b); *Coveau v. Durand*, 432 N.W.2d 662 (Wis. App. 1988).

114. *See* U.C.C., *supra* note 4, at §§ 3-401, 3-403, 3-404.

115. RESTATEMENT, *supra* note 2, at § 161.

116. *Anthony P. Miller, Inc. v. Needham*, 122 F.2d 710, 713 (3rd Cir. 1941); RESTATEMENT, *supra* note 2, at § 161 comment a.

117. *See Croissant v. Watrud*, 432 P.2d 799, 801-03 (Or. 1967) (partner engaged in acts which were neither authorized nor usually conducted by accountants; the client's reasonable belief that the partner was engaged in customary tasks, in the absence of contrary notice, was sufficient for establishing inherent agency power).

risky or (2) inhibiting commercial commerce by requiring burdensome investigation by third parties who deal with agents.<sup>118</sup> Those courts extending inherent power liability for a mistaken yet reasonable belief must achieve this balance by weighing the extent to which the unauthorized act deviates from acts which are incidental or customary in the trade or enterprise against the asserted factual basis for the reasonable belief that the agent was authorized.<sup>119</sup> Therefore, the party asserting inherent power as a basis of liability must establish that a reasonable person would conclude from the indicia of authority or facts established that the acts or promises were authorized.<sup>120</sup>

Additionally, a special agent acting for the benefit of her principal may in four limited contexts subject her principal to liability for unauthorized or disobedient acts or promises.<sup>121</sup> However, in the context of drawing, executing, signing, or completing a negotiable instrument, special agents generally lack the power to bind their principal through exercise of inherent power.<sup>122</sup> A third party payee taking delivery of a negotiable instrument from a special agent has a duty to investigate the extent of the special agent's authority.<sup>123</sup>

118. See Hetherington, *supra* note 64, at 80. Hetherington voices an additional concern for the resulting impact on the market as an institution if a balance between these competing interests are not maintained.

119. See *Gandy v. Cole*, 193 N.W.2d 58, 62 (Mich. App. 1977) (widow sued principal who operated business counseling services for gas stations after employee who used business cards identifying the principal absconded funds entrusted for management of widow's *personal* finances).

120. See, e.g., *Croissant v. Watrud*, 432 P.2d at 801-02.

121. A "special agent" is someone hired for a "one-time" or isolated transaction. Unauthorized Acts of Special Agents:

A special agent for a disclosed or partly disclosed principal has no power to bind his principal by contracts or conveyances which he is not authorized or apparently authorized to make, unless the principal is estopped, or unless:

- (a) the agent's only departure from his authority or apparent authority is
  - i. in naming or disclosing the principal, or
  - ii. in having an improper motive, or
  - iii. in being negligent in determining the facts upon which his authority is based, or
  - iv. in making misrepresentations. . . .

RESTATEMENT, *supra* note 2, at § 161A.

122. See *General Products Co., Inc. v. Bezzini*, 365 A.2d 843 (Conn. Super. 1976) (holder of a power of attorney for a limited purpose of purchasing the land signed principal's name to promissory note as guarantor for another and attached a copy of the power of attorney. When sued, grantor of the power argued that the attorney acted without authority given the limited purpose of the power of attorney. The Superior Court denied liability of grantor. Holder of the power was a special agent who cannot bind principal in excess of authority absent special circumstances); *Blackwell v. Ketcham*, 53 Ind. 184 (1876) (special agent authorized to complete and sign principal's name to note for the purchase of a mill, completed note in excess of authority given. Payee held on notice to investigate extent of authority).

123. *General Products*, 365 A.2d 843, 846; *Blackwell*, 53 Ind. at 186; see also *O'Shea v. First Fed. Sav. & L. Ass'n of Columbia*, 405 S.W.2d 180, 182-84 (Tenn.

Liability predicated on actual or apparent authority is rooted in contract law and is based on an objective manifestation by the principal. However, liability based on inherent power has a non-contractual theoretical basis. Thus, a manifestation of assent to the agent or the third party by the principal is *not* the basis of liability. Liability is relational, not consensual.<sup>124</sup> Liability for acts or promises by the agent which are consistent with the usual grant of authority may be justified on several principles because of the agency relationship. First, the agent is subject to the principal's control, hence, the principal is in the best position to supervise and prevent wrongdoing<sup>125</sup> and protect against loss.<sup>126</sup> Second, the principal's commercial enterprise directly benefits from employing and using agents and therefore should be responsible for the agent's ignorant or disobedient acts or promises.<sup>127</sup> Third, risk of loss is justifiably placed on a principal who fails to notify third parties of a deviation in the usual grant of authority for such agents.<sup>128</sup> Fourth, placing the loss on the principal promotes commercial convenience and the principal's enterprise. Placing the risk of loss on third parties by contrast imposes on them a duty to investigate the extent of an agent's authority for usual and customary acts, thus hindering rather than fostering commercial transactions.<sup>129</sup> Finally, a principal should be responsible for those reasonable expectations created by the conduct of an agent selected and placed in the commercial community by him.<sup>130</sup> Several specific sections of the Restatement implement

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1966), for an excellent discussion of the distinction between general and special agents.

124. *Kidd v. Thomas A. Edison, Inc.*, 239 F. 405 (D.C.N.Y. 1917); RESTATEMENT, *supra* note 2, at §§ 8A, 161; Mearns, *supra* note 105.

125. *Lincoln Bank v. National Life Ins. Co.*, 476 F. Supp. 1118, 1123 (E.D. Pa. 1979) (3d party's belief that agent authorized was reasonable; as between two equally innocent parties § 161 places the burden of loss of the principal, "since he is in the better position to supervise the agent's action"). See also *Party Hiring Dishonest Agent Should Bear Resulting Loss*, 2 PREVENTIVE L. REP. 188-89 (1784) (discussing *Jacobs v. Chicago Title Ins. Co.*, 709 F.2d 3 (4th Cir. 1983)).

126. See 9 A J. APPLEMAN & J. APPLEMAN, INSURANCE LAW AND PRACTICE § 5661-68 (rev. ed. 1981 & Supp. 1989); 13 M. RHODES, COUCH CYCLOPEDIA OF INSURANCE LAW §46:25 (2d ed. 1982). A principal may insure against an employee's wrongful and disobedient acts by obtaining a fidelity bond. Ultimately, a principal's loss for any breach of duty including acting inconsistently with authority may be shifted to the agent. See RESTATEMENT, *supra* note 2, at §§ 401, 383 comment e.

127. H. REUSCHLEIN & W. GREGORY, *supra* note 2, § 26. Liability based on inherent agency power is sometimes called enterprise liability. Professor Mearns suggests vicarious contractual liability as the theoretical basis for liability rather than inherent agency power. See MEARNS, *supra* note 105, at 56; Fishman, *supra* note 64, at 21.

128. See *Cange v. Stotler & Co., Inc.*, 826 F.2d 581, 590-91 (7th Cir. 1987); *O'Shea v. First Fed. Sav. & Loan Ass'n*, 405 S.W.2d 180, 184 (Tenn. 1966) (quoting 1 F. MECHEM, LAW OF AGENCY § 739 (2d ed. 1914)); RESTATEMENT, *supra* note 2, at § 161 comment a.

129. W. SELL, *supra* note 62, at § 112.

130. *Ebasco Services Inc. v. Pennsylvania Power & Light Co.*, 460 F. Supp. 163,

these policy considerations by imposing liability on the principal for various acts such as misrepresentations by the agent or acts motivated by an improper purpose.<sup>131</sup>

When an agent has express or implied authority, or has apparent authority, or exercises inherent power, one who transacts with such an agent transacts with the principal. This rule also applies to payees.<sup>132</sup>

### III. AGENCY PRINCIPLES AND SECTION 3-305(2)

An agent may, in an overabundance of zeal, engage in improper acts in disobedience of the authority given by her principal while acting on behalf of the principal.<sup>133</sup> An agent may misrepresent or conceal a material fact on the quality of goods despite contrary instructions by the principal, may accept an instrument inconsistent with authority, or may act for her own personal benefit. Each of these acts would amount to a breach of duty to the principal and might nevertheless provide the obligor with a defense in an action by the principal/payee even though the principal/payee is a holder in due course. A principal's responsibility for an agent's disobedient acts is governed by the substantive rules of agency law.

The drafters of the U.C.C. recognized the existence and applicability of agency law principles to commercial transactions and expressed an intent that the U.C.C. be supplemented by these principles unless displaced.<sup>134</sup> Through U.C.C. section 1-103, a duty is imposed on courts to apply the rules of agency law, when appropriate, to resolve issues under article three unless some express provision in article three displaces the relevant agency rule.<sup>135</sup> Thus, the principles of actual and

203 (E.D. Pa. 1978); Mearns, *supra* note 105, at 56.

131. *See, e.g.*, Homes Sav. Ass'n v. General Elec. Credit Corp., 708 P.2d 280, 283 (Nev. 1985); RESTATEMENT, *supra* note 2, at §§ 162, 164, 165, 173, 177-178A.

132. *See* Lucas' Estate v. Whiteley, 550 S.W.2d 767 (Tex. Civ. App. 1977) (promissory note executed by an agent with authority is as if executed by the principal himself).

133. *See, e.g.*, Saale v. Interstate Steel Co., 275 N.Y.S.2d 532 (1966), *aff'd*, 281 N.Y.S.2d 340 (1967) (sub-agent misrepresents quality of goods to be sold).

134. Supplementary General Principal of Law Applicable.

Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

U.C.C., *supra* note 4, at § 1-103. *See also* Terry v. Kemper Ins. Co., 456 N.E.2d 465, 467 (Mass. 1983); Moore v. Puget Sound Plywood, Inc., 332 N.W.2d 212, 215 (Neb. 1983); Utica Nat'l Bank & Trust Co. v. Associated Producers Co., 622 P.2d 1061, 1065 (Okla. 1980).

135. U.C.C., *supra* note 4, at § 1-103 comment 1. *Terry*, 456 N.E.2d at 467; *see also* Morgan Guar. Trust Co. v. American Sav. & Loan, 804 F.2d 1487, 1494-97 (9th Cir. 1986) (§ 3-418, final payment rule, does not displace remedy of restitution for

apparent authority and inherent power must be used to resolve the "dealt with" issue when either the obligor or payee is represented by an agent.

Consider the following cases based on the hypothetical situations in comment two to section 3-302 in which the drafters indicate a payee may qualify as a holder in due course. In the analysis of each example, rules of agency law are applied consistent with the rules and policies of article three.

#### Case One:

Roberta purchases a bank draft from Bank using her personal check. Bank draws the bank draft payable to Payee and issues the draft to Roberta ("Remitter"). She delivers the bank draft to Payee in exchange for goods; Payee takes in good faith without notice of a claim or defense. When Bank fails to pay, Payee sues. Bank wants to raise Remitter's defense—failure of consideration—that the goods are defective.<sup>136</sup>

In the absence of an agency relationship between Remitter and the Bank, the defense is not personal to Bank. The defense arises in the transaction between Remitter and Payee. Bank and Payee have not "dealt with" each other. No direct dealing occurs between Bank and Payee. This fact pattern is identical to that addressed by the court in *Village Motors*.<sup>137</sup> Here, commentators who believe that the comment two hypothetical situations are the only cases where the payee has not "dealt with" the obligor are correct.<sup>138</sup>

#### Case Two:

The facts are identical to those in Case 1, except that Bank raises the defense of failure of consideration because Remitter's check did not clear.<sup>139</sup>

This defense is personal to the Bank; it is an injury or loss sustained by the Bank. However, it arose in the bargain between Remitter and Bank. Again, no direct dealing or contact is made between Bank and Payee. Without more, Payee is not subject to Bank's defense.

However, if Remitter is *Payee's* agent with actual or apparent authority or inherent power to issue or negotiate the instrument to Bank, Bank in dealing with the agent (Remitter) deals with Payee (the prin-

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mistaken payment); *Spec-Cast v. First Nat'l Bank & Trust Co. of Rockford*, 538 N.E.2d 543 (Ill. 1989) (common law defenses such as ratification supplement § 3-401 which requires one's signature on a negotiable instrument before liability on the instrument may be imposed).

136. See *supra* note 26 hypothetical (a).

137. See *supra* notes 39-59 and accompanying text.

138. See *supra* note 27.

139. See *supra* note 136.

cipal).<sup>140</sup> Payee would then be subject to Bank's defense of failure of consideration. While this fact pattern on the surface is identical to that in Case One, Remitter's status as Payee's agent alters the outcome. To automatically assume that Payee in this case, or in any case, has not "dealt with" Bank because the facts are similar to hypothetical (a) to comment two disregarding the possibility of an agency relationship may lead to an erroneous outcome.

### Case Three:

Rather than issuing the draft to Remitter, Bank, at Remitter's direction, mails a bank draft to Payee who takes for value in good faith without notice of a claim or defense. Payee provides defective goods or services to Remitter. Payee sues Bank when Bank fails to pay the bank draft at Remitter's request. Bank wants to raise Remitter's defense of failure of consideration.<sup>141</sup>

Here, a court should determine whether Bank is Remitter's special agent or Remitter's co-principal or surety. Whether the funds the draft represents are loan funds for a real estate development or are Remitter's personal funds, if Bank acts on behalf of Remitter and is subject to Remitter's direction on the release of funds, Bank is Remitter's special agent.<sup>142</sup> As a special agent and a *non-party* to the contract between Remitter and Payee, Bank may *not* raise Remitter's personal defense of failure of consideration that arose from the contract between Remitter and Payee.<sup>143</sup> Bank may only raise its personal defenses such as "set-off"<sup>144</sup> if Bank "dealt with" Payee. In Case Three, if Bank is a special agent and a non-party to the contract, Payee has not "dealt with" Bank, the agent. Transacting with the principal is not synonymous with transacting with the agent (Bank). Bank's delivery of the check to Payee is an insufficient basis for satisfying the "dealt with" requirement between Bank and Payee.<sup>145</sup> Here commentators are cor-

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140. Aigler, *Payee as Holder in Due Course*, 36 YALE L.J. 608, 610 (1936) (discussing *Puget de Bras v. Forbes*, 1 Esp. 117 (C.P. 1792)).

141. See *supra* note 26.

142. See, e.g., *Dubern v. Girard Trust Bank*, 454 F.2d 565, 569 (3d Cir. 1972) (bank a compensated agent on an investment account); *Leonard Smith, Inc. v. Merrill Lynch*, 483 N.Y.S.2d 847, 848-49 (App. Div. 1985) (financial services firm an agent of customer).

143. See, e.g., *Howard Cleaners of Baltimore, Inc. v. Perman*, 176 A.2d 235, 237 (Md. 1961) (court finds questionable oral contract among agent-lender, seller, and buyer and holds agent-lender entitled to raise contract defenses); RESTATEMENT, *supra* note 2, at § 334. *But see* *Matter of Estate of Balkus*, 381 N.W.2d 593, 597-98 (Wis. App. 1985) (having dealt with the decedent, payee held to have dealt with the personal representative who stands in the shoes of the decedent).

144. W. HAWKLAND & L. LAWRENCE, *supra* note 32, at 452 § 3-305:03; *but see* *In re Johnson*, 552 F.2d 1072, 1077-78 (4th Cir. 1977).

145. *Chicago Title & Trust Co. v. Walsh*, 340 N.E.2d 106, 111-13 (Ill. App. 1975) (escrowee's discussions with Payee regarding timing for executing agreement be-



rect when they assert that the hypothetical situations reflect factual occurrences where the parties have not "dealt with" one another.

With a modification in the legal relationship between Bank and Remitter, however, a different result is produced. Consider the following modification.

Bank and Remitter are joint venturers in the construction of a building. Bank, as Remitter's co-principal, authorizes Remitter to negotiate the terms of a transaction with Payee. Without breaching his authority, Remitter concludes the transaction. At Remitter's direction, Bank forwards a bank draft to Payee who takes for value, in good faith, and without notice of a defect in the goods or services.

As a co-principal, a party to the contract, Bank may raise the failure of consideration as a defense to its obligation on the instrument.<sup>146</sup> Payee and Bank have "dealt with" one another through Remitter, Bank's agent, who exercised the express authority given.

Similarly, if the nature of Bank's relationship to Remitter is that of surety and principal, Bank as Remitter's surety may raise Remitter's defense.<sup>147</sup> Thus, the agency relationship and not the factual similarity to the comment two hypothetical determines whether the parties have "dealt with" one another. Here, the commentators' assumption proves incorrect.

#### Case Four:

*A* and *B* are partners. *A* fraudulently induces *B* to co-make a note payable to Payee. *A*, without actual authority, delivers the note to Payee for a loan purportedly to finance a venture consistent with the partnership business. Payee takes for value, without notice of a lack of actual authority and in good faith. Payee sues *A* and *B* for payment.<sup>148</sup> Payee sues on the instrument as a contractual engagement of the partnership for which *A* and *B* are jointly liable. *B* wants to raise as defenses both fraud in the inducement and *A*'s lack of authority.<sup>149</sup>

As *B*'s partner, *A* is the partnership's agent<sup>150</sup> and is also *B*'s

tween Escrowee and Escrower insufficient to satisfy the "dealt with" requirement).

146. See *Anderson v. Tway*, 143 F.2d 95, 102 (6th Cir. 1944); H. REUSCHLEIN & W. GREGORY, *supra* note 2, at § 121 (1979); W. SEAVEY, *supra* note 93, at § 125 (1964).

147. *Skaggs v. Marcus*, 57 S.W.2d 670 (Ky. 1933) (a surety may raise its principal's defenses).

148. At common law, an action brought against a partnership had to be brought against all partners. Since the obligation here is a joint obligation, both *A* and *B* must be named unless some statutory modification exists in the jurisdiction. See generally J. CRANE & A. BROMBERG, *THE LAW OF PARTNERSHIP* § 58 (1968); H. REUSCHLEIN & W. GREGORY, *supra* note 2, § 207 (1979).

149. Based on hypothetical (c), *supra* note 26.

150. UNIFORM PARTNERSHIP ACT § 9(1) (1914) [hereinafter U.P.A.].

agent.<sup>151</sup> In the absence of a contrary agreement, all partners have equal rights in the management and conduct of the partnership business<sup>152</sup> and *A* has apparent authority for conducting the ordinary business of the partnership, including executing instruments.<sup>153</sup> If *A* is a managing partner or a general manager of the partnership business, she may also have inherent power to negotiate the instrument even though she is acting on the basis of an improper motive.<sup>154</sup> In dealing with *A*, who is an agent of the partnership and the other partner, Payee has "dealt with" the partnership and with *B*. In an action on the instrument, Payee is therefore subject to *B*'s personal defenses.

In an action on the instrument brought by Payee against *B*, *B* should not prevail on the fraud in the inducement defense that is premised on *A*'s fraud upon *B*. As a principal, *B* would be entitled to raise the following defenses: (1) those that arise from the transaction between his agent, *A*, and the Payee such as failure of consideration, Payee's fraud, payment, etc.;<sup>155</sup> (2) those that result from *A*'s breach of authority if Payee had notice of *A*'s lack of authority;<sup>156</sup> and (3) the illegality of the transaction if *A* acted in collusion with Payee.<sup>157</sup> None of these, however, are applicable here.

*A* has apparent authority to issue the instrument and to receive proceeds. All partners have apparent authority for conducting the usual partnership business.<sup>158</sup> In litigating *A*'s lack of authority, Payee has the burden of proving *A*'s issuance of the note was apparently for partnership business.<sup>159</sup> Payee may satisfy the burden by establishing the

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151. U.P.A., *supra* note 150, at §§ 15 and 14 impose personal liability on each partner for partnership obligations. RESTATEMENT, *supra* note 2, at § 14A comment a; H. BAILEY & L. BRADY, ON BANK CHECKS ¶ 3.6 (6th ed. 1987).

152. U.P.A., *supra* note 150, at § 18(e). *Swiezynski v. Civiello*, 489 A.2d 634, 637 (N.H. 1985) (unless modified by agreement, each partner has equal rights in the management of the business and is an employer for the purposes of workers' compensation law); *Covalt v. High*, 675 P.2d 999, 1002 (N.M. App. 1983) (each partner's right to equal management prevents recovery of damages by one partner because of the other's failure to agree to increase in rent for partnership property).

153. U.P.A., *supra* note 150, at § 9(1). *See Lycoming Trust Co. v. Allen*, 156 A.707, 710-11 (Pa. Super. 1931) (exclusion of plaintiff's proof that partner indorsed note held as error); *Womack v. First Nat'l Bank of San Augustine*, 613 S.W.2d 548, 552 (Tex. Civ. App. 1981) (brother operating hog farm partnership had authority to bind the partnership and partner to promissory note); *Brewer v. Big Lake State Bank*, 378 S.W.2d 948 (Tex. Civ. App. 1964) (one who represents himself to be a partner is bound to promissory note executed by purported partner for conducting the partnership business).

154. U.P.A., *supra* note 150, at § 4(3); RESTATEMENT, *supra* note 2, at § 165.

155. RESTATEMENT, *supra* note 2, at § 180.

156. *See supra* note 24, discussion of payee's status as a non-holder in due course if payee has notice of an agent's lack of authority.

157. *See* RESTATEMENT, *supra* note 2, at §§ 180 comment a.

158. U.P.A., *supra* note 150, at § 9(1).

159. 1 A. BROMBERG & L. RIBSTEIN, PARTNERSHIP § 4.02 (1988).

partnership's business or the nature and scope of partnerships engaged in a similar business.<sup>160</sup> Furthermore, any failure by *B* to object to *A*'s negotiation of other instruments<sup>161</sup> on previous occasions may provide an additional basis for establishing *A*'s authority to act. However, if the partnership or *B* proves *A*'s authority was limited and Payee had knowledge of the restriction at the time of the transaction, liability can be avoided.<sup>162</sup> In the absence of notice to Payee of *A*'s limited authority, *B* has assumed the risk of *A*'s wrongdoing. Any compensation for *B*'s loss or injury should be redressed in an action by *B* against *A* for breach of her fiduciary duty.<sup>163</sup> Although *B* "dealt with" Payee, those facts *B* would seek to establish in order to show *B* was fraudulently induced by *A* to sign the instrument will not limit *B*'s liability to Payee.

However, assume that *A* misrepresents the nature of the writing *B* signs. *A*'s conduct might constitute *fraud in the factum* and *B* could raise this fraud as a real defense against payment.<sup>164</sup> Section 3-305(2) subjects all holders in due course to real defenses<sup>165</sup> and therefore those seeking to raise a real defense are relieved of establishing the "dealt with" requirement. This express provision implements a public policy concern that negotiable instruments should be intentionally and knowingly made<sup>166</sup> and displaces the rule of agency law that limits the defenses that a principal may raise. Although *B* might raise *fraud in the factum*, assuming the facts provide a good faith basis for the defense, it is nevertheless unlikely that he will prevail given his business background. *B* must establish "excusable ignorance" of the nature of the writing or its terms at the time it was signed, as well as an absence of a reasonable opportunity to obtain such knowledge.<sup>167</sup>

Thus, in Case Four, though *B* has "dealt with" Payee within the

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160. *Id.*

161. *See, e.g.,* Zimmerman v. Hogg & Allen, Professional Ass'n, 209 S.E.2d 795 (N.C. App. 1974).

162. 1 A. BROMBERG & L. RIBSTEIN, *supra* note 159, at § 4.7.

163. As a general rule, an action at law may not be maintained between partners with respect to partnership transactions until there has been an accounting or settling of partnership affairs. *Davis v. Fisher*, 184 S.W.2d 400, 402 (Tenn. App. 1944). However, there are several recognized exceptions to this rule including fraudulent conduct by one partner appropriating partnership assets for personal benefit or use as described here. *See, e.g.,* Laughlin v. Haberfelde, 165 P.2d 544, 549 (Cal. Dist. Ct. App. 1946); *Snow v. Adamson*, 385 S.W.2d 759, 761 (Tenn. 1965).

164. The elements for establishing *fraud in the factum* (real or essential fraud) are identified in U.C.C., *supra* note 4, at § 3-305 comment 7.

165. U.C.C., *supra* note 4, at § 3-305(2)(c).

166. U.C.C., *supra* note 4, at § 3-305(2) comment 7.

167. *Christinson v. Venturi Constr. Co.*, 440 N.E.2d 226, 230 (Ill. App. 1982) (*fraud in factum* defense unavailable to buyer who lacked knowledge of the nature of a trade acceptance but who failed to call his bank for advice when given the opportunity); *State Bank of Albany v. Roarke*, 458 N.Y.S.2d 300 (App. Div. 1983) (*fraud in factum* defense unavailable to obligor on promissory notes who was an educated, literate person and who had an opportunity to determine the nature of the instrument).

meaning of U.C.C. section 3-305(2), *B* should not prevail on the personal defenses of lack of authority or fraud in the inducement. Again, the assumption that the parties have *not* "dealt with" one another is an oversimplification and is incorrect.

Case Five:

*A* is Maker's general manager with authority to deliver and negotiate Maker's instruments. *A* induces Maker by fraud to execute a note payable to Payee. *A*, without notice to Payee, issues the note for her personal benefit. Payee takes for value and in good faith.<sup>168</sup>

In issuing the instrument to Payee, *A* is not acting on Maker's behalf but rather for herself or with an improper motive. Assuming that Payee does not have notice of *A*'s improper motive or of her failure to act for her principal,<sup>169</sup> Maker will not prevail in his defense to his liability in an action brought by Payee on the instrument.<sup>170</sup> By engaging in acts similar in nature to those authorized by Maker, *A* has inherent power to issue the instrument even though she lacks actual and apparent authority to issue the instrument for her personal benefit.<sup>171</sup> Because of *A*'s exercise of inherent power Maker "deals with" Payee. No defense is available to Maker. The act is binding because of *A*'s inherent power.

However, should Payee fail to establish that either *A* has apparent authority by virtue of some manifestation by Maker directed to Payee, or that *A* has inherent power by a showing that *A* engaged in acts similar to those that have been authorized or ratified by Maker, Maker will have a defense but will not have "dealt with" Payee. Even though Maker and Payee may have had prior direct dealings or may have authorized dealings through agents including *A* involving other negotiable instruments, the conclusion that the parties have *not* "dealt with" one another is correct. Assume the following facts: Ms. *X* obtains goods from Ms. *Y* and signs a promissory note. Ms. *X*'s employee induces her by fraud to sign several checks payable to Ms. *Y* that are used by the employee for unauthorized purposes. Ms. *X* discovers the fraud and stops payment on the checks. Ms. *Y* sues and asserts that she is a holder in due course of these checks. Ms. *X* would not prevail if she argues she "dealt with" Ms. *Y* when the promissory note was issued in transaction number one and that Ms. *Y* is therefore subject to the personal defense of fraud in the inducement.<sup>172</sup>

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168. Based on hypothetical (d), *supra* note 26.

169. Use of the principal's instrument for a personal obligation may itself provide notice. *See infra* note 173.

170. RESTATEMENT, *supra* note 2, at § 165.

171. *See supra* notes 104-32 and accompanying text.

172. *But see* Travelers Indem. Co. v. American Express Co., 559 F. Supp. 452, 453 (S.D.N.Y. 1983). Court holds the holder in due course is subject to employer's

Ms. *X* seeks to use an unrelated transaction, the goods-note transaction, as a basis for limiting her liability on checks issued subsequent to and directed for payment of a separate and distinct obligation. Direct dealings between two parties in unrelated transactions should not form the basis for subjecting a holder in due course to personal defenses. Such a rule undermines and impairs the U.C.C.'s policy of creating a market for negotiable instruments, fails to give effect to the language of section 3-305(2) that subjects the holder in due course to personal defenses on the instrument for which payment is sought, and imposes burdensome luggage of prior transactions on an instrument. Any other rule requires a holder in due course to treat all instruments received in a commercial relationship as a part of one continuous transaction.

Unless Ms. *Y* can establish employee's inherent power, which requires at least a showing that issuing checks was an act consistent with employee's position and that Ms. *Y* reasonably believed that employee was authorized<sup>173</sup> to act on behalf of Ms. *X* in transaction number two or apparent authority based on prior dealings,<sup>174</sup> there is no basis for the conclusion that the parties have "dealt with" each other. Before a party who is a holder in due course can be subject to personal defenses on an instrument, the principal/obligor must show that the "dealt with" requirement has been met in the transaction in which the instrument that is the subject of the action was issued or negotiated. The

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defense of employee's fraud when parties to an instrument "have previously dealt with one another" without discussing agency principles. The court's language suggests that if parties have *any* dealings not including the instrument in question the "dealt with" requirement is satisfied.

173. Knowledge of an agent's use of his principal's instrument for a personal obligation provides notice of a claim. U.C.C., *supra* note 4, at § 3-304(2). *See City of Newburyport v. Fidelity Mut. Life Ins. Co.*, 84 N.E. 111, 112 (Mass. 1908). In *City of Newburyport*, the city treasurer drew a check on city's account in payment of personal life insurance policy. The Massachusetts Supreme Court held that insurer had knowledge of fiduciary's breach of duty. Here, receiving a principal's instrument for a personal obligation without more satisfied the knowledge requirement.

Some jurisdictions require actual knowledge based on a subjective test rather than an objective standard, reason to know or constructive notice, to satisfy the knowledge requirement. *See, e.g., Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 207 N.W.2d 282, 287 (Minn. 1973) (actual knowledge or knowledge of facts from which payee could reasonably infer a breach of fiduciary duty is necessary); *Hartford Accident & Indem. Co. v. American Express*, 542 N.E.2d 1090 (N.Y. 1989) (agent requests checks payable to fictitious payees whose names are misnomers of agent's personal creditors); *G.F.D. Enterprises, Inc., v. NYE*, 525 N.E.2d 10, 15-16 (Ohio 1988) (mere knowledge that the person negotiating an instrument stands in a fiduciary capacity is insufficient to satisfy the notice requirement).

If Ms. *X*'s employee used the checks for personal obligations owed Ms. *Y*, then Ms. *Y* may have notice of a claim and would not be a holder in due course. *See also* hypothetical (e), *supra* note 26.

174. *See supra* note 91 and accompanying text.

“dealt with” requirement should be satisfied for each instrument in unrelated transactions.

To conclude Case Five, if Payee fails to establish either *A*'s apparent authority or *A*'s inherent power to act for Maker, Payee should be held to have notice of a claim or defense and therefore should not be a holder in due course. Maker may then raise the defense under section 3-306. If *A* has inherent power or apparent authority to act, Payee will be a holder in due course who “dealt with” Maker but Maker will not have a defense of lack of authority to limit his obligation to pay. Again, any assumption based on the comment two hypothetical that the parties have “dealt with” one another may lead to an incorrect result.

#### Case Six:

Seller engages *A* as auctioneer to sell antiques, cash on delivery. Seller authorizes *A* to describe the vintage and historical value of the goods. *A*, believing the goods are early 1600 French, describes them as such without knowing that the pieces are, in reality, excellent reproductions. After inspecting the goods, Buyer offers to purchase the goods, 10% down balance evidenced by promissory notes. *A*, a special agent and without authority to accept credit terms, refers Buyer to Seller who accepts the credit terms. Buyer delivers the notes drawn payable to Seller and the 10% down to *A*. Seller takes the notes for value, in good faith and without notice of the misrepresentation by *A*. Seller is a holder in due course. After delivery of the goods, Buyer refuses to pay notes when due. Seller sues on the notes. Buyer asserts fraudulent misrepresentation and failure of consideration because of *A*'s erroneous description of the goods at the time of sale. Is Seller subject to these defenses?<sup>175</sup>

*A* is an agent with actual authority to sell and to truthfully describe the goods. Seller, as *A*'s principal, is responsible for authorized as well as unauthorized representation if the representations are incidental to an authorized contract and if the making of representations is within the agent's authority.<sup>176</sup> If auctioneers in the locality where *A*

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175. Based on hypothetical (d), *supra* note 26.

176. See RESTATEMENT, *supra* note 2, at §§ 161A(a)(iv), 162; *Miller v. Premier Corp.*, 608 F.2d 973, 980 (4th Cir. 1979) (nonexclusive agent makes unauthorized and prohibited representations). *But cf.* *Saale v. Interstate Steel Co.*, 275 N.Y.S.2d 532 (1966); *aff'd*, 281 N.Y.S.2d 340 (1967). In *Saale* Insured imported steel coils from Japanese supplier for resale. Coils arrived in damaged condition. Insured notified Insurer of loss and was told that Insured would be paid in full for the loss. To determine the amount of loss, Insurer engaged Surveyor who advertised the goods for sale and held an auction after giving prospective buyers an opportunity to inspect. Buyer, the highest bidder, requested credit terms. Buyer was advised that Insured must approve any credit terms. After negotiations with the Insured, Buyer concluded the transaction by paying \$50,000 cash and issuing three promissory notes, payable to Insured. Insured then signed a release of the goods to the Buyer. Thereafter, Buyer dishonored the second note when present by payment asserting fraudulent misrepresentation by Insured's agents. 275 N.Y.S.2d at 533.

auctioned the goods usually warrant the vintage or historical significance of goods, *A*'s actual authority to sell would be interpreted as including the authority to give customary warranties, even if Seller failed to expressly authorize *A* to describe the vintage or historical significance of the goods.<sup>177</sup> Here, however, Seller's responsibility is grounded in *A*'s inherent power.<sup>178</sup> *A* made representations that *A* honestly believed were true and that were similar in nature to those specifically authorized by Seller. Seller is responsible for *A*'s mistaken yet honest representations.<sup>179</sup>

Pursuant to the rules of agency law, the representations by *A* are imputed to Seller. One who engages an agent must assume some risk if deviations occur, especially in the absence of notice of a deviation by an innocent third party incidental to an authorized contract.<sup>180</sup> *A* is Seller's authorized representative and acts by an agent within the scope of the agent's actual, apparent, or inherent power are the acts the principal.<sup>181</sup> Having "dealt with" *A*, an agent exercising inherent power, Buyer "dealt with" Seller. Although a holder in due course, Seller is subject to Buyer's defenses.

Assume, however, that *A* has knowledge that the pieces are excellent reproductions and untruthfully represents the goods as authentic 1600 French. Seller sues Buyer on the notes when Buyer fails to pay. Again, Buyer asserts fraud in the inducement and failure of consideration and Seller asserts he is a holder in due course.

Here, Seller is not a holder in due course under the facts as modified. *A* holder in due course is one who takes an instrument without notice that any person may have a defense against the instrument or a

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The majority of the court held Insured, the payee, was a holder in due course and not subject to Buyer's personal defense. *Id.* at 535-36. The majority failed to determine if the Insurer was the Insured's agent and whether the Surveyor was the Insured's sub-agent. The language used by the court suggests that the court found as a matter of law that no agency relationship existed. The agency question is correctly stated by the sole dissenter: Was the Insurer, as a special agent, acting on behalf of the Insured, and subject to the Insured's control in conducting the salvage sale? The facts strongly suggest that an agency relationship existed between the Insured and the Insurer: Insured retained title; Insured received proceeds of sale as part of the satisfaction of its claim; the amount of Insurer's liability was determined by the difference between the original purchase price for the goods and the amount recovered through the salvage sale; Insured set the terms of the salvage sale of the goods. *See generally* 275 N.Y.S.2d at 536-38. If the Insurer was an agent of the Insured and empowered to appoint the Surveyor to perform Insurer's duty to sell the coils, the Insured as principal for both was responsible for the unauthorized acts of the Surveyor. RESTATEMENT, *supra* note 2, at § 5(1) comment d.

177. RESTATEMENT, *supra* note 2, at § 63.

178. *Id.* at §§ 161(A)(iv) 145 comment c.

179. *Id.* at § 145 comment c.

180. *Id.* at § 63 comment f.

181. *Lucas v. Whiteley*, 550 S.W.2d 767 (Tex. Civ. App. 1977).

claim of ownership to it.<sup>182</sup> Under article three of the U.C.C., one has notice of a fact if one has actual knowledge,<sup>183</sup> or has received notice or notification,<sup>184</sup> or has a reason to know a fact based on existing facts and circumstances.<sup>185</sup>

As a general rule, a principal's knowledge may be affected by the agent's knowledge at the time the agent engages in a transaction.<sup>186</sup> An agent's knowledge at the time he transacts with another on behalf of his principal and consistent with his or her actual or apparent authority is imputed to the principal.<sup>187</sup> Where the transaction is one within the agent's apparent authority, some authorities state that the third party must rely on the appearance of authority before the agent's knowledge is imputed to the principal.<sup>188</sup> These authorities appear to be requiring apparent authority as to the party seeking to impute the agent's knowledge to the principal.<sup>189</sup> If the party seeking to impute knowledge to the principal has no knowledge of the principal's manifestation and does not act consistent with a reasonable interpretation of that manifestation, there is no apparent authority.<sup>190</sup> Reliance should not be necessary.

However, if the agent acts within his actual or apparent authority, the agent's actual knowledge as well as those facts that a reasonable person in the agent's position would know under the circumstance is imputed to the principal.<sup>191</sup> There is, however, an exception to this rule

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182. U.C.C., *supra* note 4, at § 3-302(1)(c).

183. U.C.C., *supra* note 4, at § 1-201(25)(a).

184. *Id.* at (25)(b).

185. *Id.* at (25)(c).

186. RESTATEMENT, *supra* note 2, at § 272; W. SEAVEY, *supra* note 93, at §§ 97, 98. See generally Merrill, *The Anatomy of Notice*, 3 U. CHI. L. REV. 417 (1936); Seavey, *Notice Through An Agent*, 65 U. PA. L. REV. 1 (1916).

187. *Wilder v. Baker*, 362 P.2d 1045 (Colo. 1961) (collecting agents' knowledge of debtor's bankruptcy not imputed to principal where agents' only authority was to collect installment payments); *District-Realty Title Ins. Corp. v. Forman*, 518 A.2d 1004 (D.C. 1986) (agent's actual knowledge acquired before employment with principal imputed to principal); *MacQuinn v. Patterson*, 85 A.2d 183 (Me. 1951) (gardener's knowledge that contractor delivered gravel to principal's property before consulting with gardener not imputed to principal where gardener's express and apparent authority required contractor to consult with gardener before commencing work); RESTATEMENT, *supra* note 2, at §§ 272, 273; W. SEAVEY, *supra* note 93, at § 98k.

188. RESTATEMENT, *supra* note 2, at § 273; W. SEAVEY, *supra* note 93, at § 98k.

189. See, e.g., RESTATEMENT, *supra* note 2, at § 273 illustration 1. Here, there is no manifestation by the principal to B and, therefore, no apparent authority; see also *MacQuinn v. Patterson*, 85 A.2d 183 (Me. 1951).

190. RESTATEMENT, *supra* note 2, at § 27.

191. *District-Realty Title Ins.*, 518 A.2d at 1008 n. 4 (agent's actual knowledge imputed to principal); *Somerville Nat'l Bank v. Hornblower*, 199 N.E. 918 (Mass. 1936) (broker who sold securities delivered in error by bank held to clerk's actual knowledge that securities were delivered on condition that a check was to be returned for securities). *Wheatland v. Pryor*, 30 N.E. 652 (N.Y. 1892) (bank, as agent for depositor, lacked actual knowledge that partner used partnership funds to pay an individ-



of imputed knowledge.<sup>192</sup> An agent's knowledge is not imputed to the principal if the agent acts in collusion with the other party to the transaction<sup>193</sup> or the agent acts for his own purposes adverse to the principal's interest,<sup>194</sup> other than to increase his commissions in transactions that are mutually benefitting to both the principal and the agent.<sup>195</sup>

This exception to the imputed knowledge rule is inapplicable if the agent who acts adverse to the principal is the principal's sole representative in the transaction and the principal seeks to enforce or retain benefits which accrue to him or her from the transaction.<sup>196</sup> In this instance, the agent's knowledge is imputed to the principal even though the agent acted for his or her own purposes.<sup>197</sup>

A, in the modified version of Case Six, knew at the time of the sale to Buyer that the goods were in fact reproductions and untruthfully represented them as authentic. Seller authorized A to sell the goods and to represent their vintage and historical value truthfully. A acted for Seller's benefit in conducting the sale and did not act in collusion with Buyer. Therefore, A's knowledge of the falsity of his statements is imputed to Seller at the time Seller takes the notes.

Seller has notice of a defense to the instrument and is not a holder in due course.<sup>198</sup> As a non-holder in due course, Seller is subject to the

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ual obligation; collecting bank's knowledge, as agent for bank but not depositor's sub-agent, not imputed to depositor).

192. *Hays v. Bank of Arizona*, 110 P.2d 235, 237 (Ariz. 1941).

193. *Boles v. Hartsfield Co.*, 178 S.E. 416 (Ga. Ct. App. 1935) (wife who signed blank note as sole obligor to secure loan for lender's agent in violation of lender's policy and statute prohibiting suretyship contracts by married women held to obligation when court refused to impute agent's knowledge to principal because of the agent's collusion with the wife).

194. *Clapp v. Wallace*, 266 N.W. 493 (Iowa 1936) (bank officer cancelled note on which he was an accommodation; indorsed and received in substitution a note without his accommodation. Officer's knowledge of the release not imputed to bank as his principal). *American Cotton Co-op. Ass'n v. Union Compress & Warehouse Co.*, 7 So.2d 537, 540 (Miss. 1942) (warehouseman's agent deliberately failed to cancel negotiable warehouse receipts received in exchange for cotton stored by association but delivered receipts to association's agent who participated in the fraud to obtain money from the association against the receipts; agent's knowledge of the fraud was not imputed to the association in its suit against the warehousemen).

195. *In re Miffin Chemical Co.*, 123 F.2d 311, 315-16 (3d Cir. 1941).

196. *Connecticut Fire Ins. Co. v. Commercial Nat'l Bank*, 87 F.2d 968, 969 (5th Cir. 1937) (agent's knowledge imputed to principal who claims benefits from agent's fraudulent acts contrary to principal's interest as a sole actor or representative to principal's interest). *Supreme Petroleum, Inc. v. Briggs*, 433 P.2d 373, 378-79 (Kan. 1967) (summary judgement inappropriate, fact finder must determine if evidence sufficient to support conclusion that fraudulently acting agent was corporation's sole agent where corporation sued to enforce promissory note).

197. *Connecticut Fire Ins. Co.*, 87 F.2d at 969-70; *Supreme Petroleum*, 433 P.2d at 378-79.

198. See U.C.C., *supra* note 4, at § 3-304.

defenses asserted by Buyer.<sup>199</sup> In addition to being a non-holder in due course and subject to Buyer's defenses, Seller is also responsible for A's misrepresentations made incidental to an authorized contract.<sup>200</sup>

Case Seven:

Drawer authorizes Agent, a regular employee, to purchase goods from Seller and to use checks payable to Seller but blank as to amount for payment. Drawer authorizes Agent to complete the checks and limits the amount of purchase and the amount of any check to a sum not to exceed \$100,000. Drawer mails to Seller a letter identifying Agent as his regular employee who may make purchases on his behalf and stating that the purchases will be paid for by check to be completed as to amount by Agent at the time of purchase. No limitation on the amount of purchase or check is specified. Over a period of six months, Agent makes twelve or more purchases including one for \$115,000. Drawer receives the goods from each purchase and retains them without objection. Agent then purchases goods for \$150,000 which later fail to function as warranted by Seller. Seller, at the time of purchase, takes the check in good faith, without notice of the defect. Drawer stops payment on the check and Seller sues. Drawer wants to raise failure of consideration and lack of authority as defenses. Seller asserts she is a holder in due course and not subject to either defense.<sup>201</sup>

Agent has express authority to purchase goods and to complete the check for an amount not to exceed \$100,000. Drawer's letter to Seller is a manifestation to Seller that gives Agent apparent authority to purchase goods without limitation as to amount and to complete checks for an amount equivalent to the market price or reasonable price of the goods.<sup>202</sup> Drawer's retention of goods previously purchased in excess of Agent's authority with knowledge of Agent's violation of authority but without objection is an additional manifestation upon which Seller may rely for Agent's apparent authority to purchase and complete the check for an amount in excess of \$100,000.<sup>203</sup> These manifestations form a

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199. U.C.C., *supra* note 4, at § 3-306(b) and (c).

200. RESTATEMENT, *supra* note 2, at § 162 comment b, illustration 1.

201. Based on hypothetical (f) and (g), *supra* note 26. A signed writing missing a necessary particular whether the sum payable or the payee is an incomplete instrument within U.C.C., *supra* note 4, at § 3-115. In hypothetical (g), the eighth hypothetical in comment 2, an agent completes an instrument contrary to express authority by naming his personal creditor as payee rather than naming the payee designated by the principal. Resolution of the "dealt with" requirement for hypothetical (g) includes the analysis discussed in Case Seven for an incomplete instrument and the issue of whether the payee has notice of a defense under U.C.C., *supra* note 4, at § 3-304 because of fiduciary's use of the principal's instrument for a personal obligation as discussed in *supra* note 173.

202. The authority to buy is interpreted to include the authority to buy at market price or reasonable price. RESTATEMENT, *supra* note 2, at § 61.

203. *See, e.g.,* Southern Portland Cement v. Beavers, 478 P.2d 546, 549 (N.M.).

sufficient basis—in the absence of facts establishing Seller's notice of Agent's lack of authority—for Seller's reasonable belief that Agent is authorized to purchase the goods for \$150,000.<sup>204</sup>

Drawer's secret instruction to Agent is an ineffective limitation on Agent's apparent authority.<sup>205</sup> As between Drawer and Seller, an innocent third party without notice of Agent's lack of authority, Drawer should assume the risk of Agent's breach of duty. Thus, Agent is authorized and Drawer should not prevail on the defense of lack of authority.

Because Agent is authorized, Agent's acts are Drawer's acts. Hence, Drawer "dealt with" Seller and may raise the defense of failure of consideration even though Seller is a holder in due course. Furthermore, given Agent's apparent authority to complete the instrument, it may be enforced as completed.<sup>206</sup>

Here, Seller is a holder in due course as the drafters envisioned. Having "dealt with" Drawer through an authorized agent, Seller is subject to Drawer's personal defense and Seller has not gained any additional unearned protection from personal defenses or lost any benefits to which a holder in due course in a similar transaction with a primary party would have been entitled. The hypothetical situations in comment two to section 3-302 demonstrate factual patterns in which a payee may be a holder in due course and nothing more.

#### CONCLUSION

The foregoing cases are adaptations of the hypothetical situations in comment two to section 3-302. These provide examples of fact patterns wherein a payee may be a holder in due course. As the Cases indicate, factual similarity to the comment two hypothetical situations is but the beginning of the inquiry for determining if a payee who is a holder in due course has "dealt with" the obligor. The rules of agency law must be applied to determine an agent's power to act on behalf of his principal before resolving the "dealt with" question. If the agent has actual or apparent authority, or inherent power to act, a payee who "deals with" an obligor's agent "deals with" the principal and is subject to personal defenses (contract defenses) arising from the transaction with the agent. However, the payee is not subject to a defense

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1970). See also Conant, *supra* note 64, at 682.

204. The question of Agent's apparent authority is one of fact unless the facts are undisputed. *Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co.*, 156 A. 350 (Del Super. 1931); *W. SEAVEY*, *supra* note 93, at § 16B (1964). However, interpretation of a writing for a determination of authority is a question of law for the judge. *Id.*

205. *Sneed v. First Nat'l. Bank*, 249 S.E.2d 322, 323 (Ga. Ct. App. 1978); RESTATEMENT, *supra* note 2, at § 160.

206. U.C.C., *supra* note 4, at § 3-115(1).

arising from the agent's conduct with the principal in the absence of collusion by the payee with the agent or conduct by the agent constituting a real defense. If the payee has notice of the agent's breach of duty, the payee is not a holder in due course.

Likewise, conduct by the payee's agent that is the exercise of actual or apparent authority or inherent power is effective as if performed by payee. In the absence of obligor's notice of the agent's breach of duty or lack of authority, or collusion with the payee's agent, such conduct should be a defense to payment.

The rules of agency law are relevant to issues arising under article three and must be applied unless displaced. If the rules for determining an agent's authority are used to resolve the "dealt with" question, a payee will gain the rights and privilege of holder in due course status when earned, without depriving an obligor of the right to raise personal defenses when appropriate. Consistent results will then be produced whether the transaction involves primary parties or representatives.