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## Section 3-408: Problems of "Want or Failure of Consideration"

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# UNIFORM COMMERCIAL CODE COMMENTARY

## SECTION 3-408: PROBLEMS OF "WANT OR FAILURE OF CONSIDERATION"

Article 3 of the Uniform Commercial Code<sup>1</sup> establishes rules for transactions in commercial paper and sets forth the rights and liabilities of parties to these transactions. One of the sections which establishes the liabilities of the parties is section 3-408 which states the conditions under which the defense of want or failure of consideration operates. Section 3-408 provides:

Want or failure of consideration is a defense as against any person not having the rights of a holder in due course (section 3-305), except that no consideration is necessary for an instrument or obligation thereon given in payment of or as security for an antecedent obligation of any kind. Nothing in this section shall be taken to displace any statute outside this act under which a promise is enforceable notwithstanding lack or failure of consideration. Partial failure of consideration is a defense pro tanto whether or not the failure is in an ascertained or liquidated amount.<sup>2</sup>

Section 3-408 is written clearly and it seems unlikely that interpretive problems would arise. However, when this section is read in conjunction with various other provisions of Article 3, interpretive problems do arise. The purpose of this comment is to show how these problems arise in the application of section 3-408 to suits on checks,<sup>3</sup> and to show how these problems might be reconciled within the context of the Code.

The simplest situation in which section 3-408 applies is a suit on a check brought by the holder<sup>4</sup> against the drawer<sup>5</sup> with whom he has dealt. Consider the hypothetical situation in which A gives B a check in payment for repairs to A's automobile. A then finds that the repairs are defective and stops payment<sup>6</sup> on the check. After dishonor<sup>7</sup> by A's bank because of the

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<sup>1</sup> All Uniform Commercial Code citations are to the 1962 Official Text.

<sup>2</sup> A discussion of the ramifications of the "antecedent obligation" and "statute displacement" provisions of § 3-408 is not within the scope of this comment. It appears that these provisions raise no substantive difficulty.

<sup>3</sup> U.C.C. § 3-104 defines a check as a writing signed by the drawer containing an unconditional promise to pay a sum certain in money, drawn on a bank and payable on demand, to order or to bearer.

<sup>4</sup> U.C.C. § 1-201(20) defines a holder as "a person who is in possession of a document of title or an instrument or an investment security drawn, issued or indorsed to him or to his order or to bearer or in blank."

<sup>5</sup> A drawer is the person signing the check, directing one called the drawee or payor to pay another person called the payee a sum certain in money. See, e.g., *Boatenreiter v. Williams*, 58 Ga. App. 635, 636, 199 S.E. 558, 559 (1938); *Westminster Bank v. Wheaton*, 4 R.I. 30, 33 (1856).

<sup>6</sup> U.C.C. § 4-403(1) states:

A customer may by order to his bank stop payment of any item payable for his account but the order must be received at such a time and in such manner

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stop payment order, the check returns to B through the clearing process<sup>8</sup> and B sues A on the check.

Section 3-413(2) of the Code, which prescribes the liability of a drawer of a check, states: "The drawer engages that upon dishonor of the draft and any necessary notice of dishonor or protest he will pay the amount of the draft to the holder or to any indorser who takes it up." This section is cast in absolute language and states that a drawer who has not drawn "without recourse"<sup>9</sup> must upon demonstrated compliance with the provisions of this section pay the amount of the check to any holder.<sup>10</sup> On its face, section 3-413(2) provides no substantive defenses to the action by the holder on the check and it therefore appears that the party suing need only qualify as a holder to obtain automatic recovery on the instrument. The Code does, however, provide for the application of substantive defenses in suits by payee holders against drawers and it is in this context that section 3-408, providing for the defense of failure of consideration, becomes important.

Section 3-408 states that the defense of lack or failure of consideration is applicable against any person who does not have the rights of a holder in due course.<sup>11</sup> Thus the drawer in the hypothetical situation can raise the defective condition of the repairs performed by the holder as consideration as a defense against payment on the check, and unless the holder is a holder in due course the drawer's defense will prevail. The requirement of section 3-408 that the holder be a holder in due course to avoid the defense of lack or failure of consideration has important practical ramifications in suits between drawers and holders. A holder may, according to the Code, bring suit to enforce payment in his own name.<sup>12</sup> The defendant drawer may, however, force the plaintiff holder to prove that he is a holder in due course by showing that there is a valid defense of lack or failure of consideration. Once it is shown that such a defense exists, the holder can only

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as to afford the bank a reasonable opportunity to act on it prior to any action by the bank with respect to the item described in Section 4-303.

<sup>7</sup> U.C.C. § 3-507(1)(a) states that an instrument is dishonored when a "necessary or optional presentment is duly made and due acceptance or payment is refused or cannot be obtained within the prescribed time or in case of bank collections the instrument is seasonably returned by the midnight deadline (Section 4-301) . . ."

<sup>8</sup> For an explanation of the clearing process see, e.g., Leary, *Check Handling Under Article Four of the Uniform Commercial Code*, 49 *Marq. L. Rev.* 331 (1965).

<sup>9</sup> By drawing the instrument "without recourse," the drawer disclaims liability on the instrument if it is dishonored. See U.C.C. § 3-413(2).

<sup>10</sup> Before the commencement of a suit against the drawer on the check, the Code requires that the holder give the drawer notice of dishonor and protest (§ 3-501(2)(b), (3)). If he does not do so within a reasonable time (§ 3-508(2)), and the drawee bank becomes insolvent within this time, the drawer may discharge his liability by assigning his rights against the payor bank to the holder in writing (§ 3-502(b)). Failure to protest where necessary (§ 3-501(3)) discharges the drawer's liability automatically (§ 3-502(2)). In situations such as the hypothetical, however, where the drawer knew or had reason to know of the dishonor, the notice of dishonor and protest are excused. (§ 3-511(2)(b)).

<sup>11</sup> The rights of a holder in due course are set forth in U.C.C. § 3-305. In order to become a holder in due course under U.C.C. § 3-302, the holder must take for value, in good faith, and without notice that the instrument is overdue or has been dishonored. A payee may be a holder in due course under the Code. See U.C.C. § 3-302(2).

<sup>12</sup> U.C.C. § 3-301.

avoid losing the suit by showing that he is a holder in due course and hence immune to this defense.<sup>13</sup>

The defendant may, therefore, by showing the existence of the defense, place the burden of proving his right to recover upon the plaintiff. He must prove that he took the check for value, in good faith and without notice, and that it was not overdue or dishonored. In the hypothetical situation, however, the holder has a serious problem in proving that he took the check for value. The Code stipulates that a holder takes for value only to the extent that he has performed the agreed upon consideration.<sup>14</sup> Since the hypothetical stated that the repairs were defective, he did not fully perform the agreed consideration and therefore would not be a holder in due course. It should be noted that value and consideration are not intended to be used interchangeably under Article 3.<sup>15</sup> Consideration is that which the drawer receives in return for drawing the check,<sup>16</sup> while value is that which the holder gives for receiving the check.<sup>17</sup> In situations like the hypothetical, where the parties dealt with one another, the two are in fact identical. In situations where the parties have not dealt with one another, the consideration received by the drawer and the value given by the holder would be elements of different transactions and thus would be, in fact, different.

The hypothetical situation set out above represents the simplest instance in which section 3-408 applies because there were only two parties involved in the transaction and these two parties necessarily dealt with each other. The only party that the holder can sue is the drawer, and therefore there seems to be no reason to question the propriety of the application of the defense of lack or failure of consideration as set forth in section 3-408.

The propriety of the application of section 3-408 to a suit on a check becomes questionable, however, when more than two parties are involved in the transaction. Consider a situation in which I contracts with H for auto repairs, and in payment therefor gives H a check, drawn by D, payable to I, and bearing I's indorsement. Before H can obtain payment on the check, I finds that the repairs are defective, and has payment stopped on the check.<sup>18</sup> The Uniform Commercial Code provides no means whereby an indorser can stop payment on a check.<sup>19</sup> In Comment 3 to section 4-403, it is stated that the Code follows the rule that a "payee or indorsee has no right to stop payment" on a check. It appears, then, that the only way that an indorser can stop payment on a check is to request the drawer to stop payment in his behalf.

<sup>13</sup> See U.C.C. § 3-307(3).

<sup>14</sup> See U.C.C. § 3-303(a).

<sup>15</sup> U.C.C. § 3-408, Comment 1. See also U.C.C. § 3-303, Comment 2.

<sup>16</sup> See U.C.C. § 3-408, Comment 1.

<sup>17</sup> See U.C.C. § 3-303, Comment 2. See also *Value and Consideration for Checks*, 78 *Banking L.J.* 921, 922-23 (1961).

<sup>18</sup> The situation described in the hypothetical represents the basic fact pattern of a case recently decided under the Code, *Brotherton v. McWaters*, 438 P.2d 1 (Okla. 1968).

<sup>19</sup> Payment may be denied for a number of reasons including lack of funds, no account in the drawer's name, forgery, or a stop payment order by the drawer. A discussion of the effects of each reason for denial of payment is not within the scope of this comment. Discussion will therefore be limited to the situation where the indorser prevails upon the drawer to stop payment in his behalf.

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Assuming that the indorser has successfully had payment stopped by the drawer, H, the holder, has three alternatives for recovery. The first alternative is a suit against the drawer of the check, while the other alternatives are a suit against the indorser on the underlying obligation or a suit against the indorser on the check.

The liability of the drawer on the check in this hypothetical, as in the first hypothetical, is prescribed by section 3-413(2). There is, however, one major difference between the two hypotheticals. In the first the parties dealt with one another, while in the second, the parties to the suit did not. The fact that the parties did not deal with one another in the second hypothetical seriously affects the applicability of section 3-408.

In the first case, the consideration discussed in section 3-408 and the value required of a holder in due course by section 3-303 were the same because the parties had dealt with one another. In the present hypothetical, the parties did not deal with one another and, therefore, the value and the consideration are distinguishable. The consideration in the present hypothetical would be what D, the drawer, received from the indorser in exchange for drawing the check. On the other hand, the value in this situation is that which the holder, H, gave to the indorser in exchange for receiving the check.

The hypothetical stipulates that the value (*i.e.*, the consideration given the indorser by the holder) was defective. Therefore, the holder cannot be a holder in due course because this consideration between himself and the indorser is not sufficient.<sup>20</sup> If the holder is not a holder in due course, section 3-408 states that the holder will not be immune to the defense of lack or failure of consideration. But herein lies the major difference between the two hypothetical situations. If the *indorser* has properly performed the consideration due the drawer for the check, the drawer cannot rightfully plead the defense of lack or failure of consideration under section 3-408 and the holder, in the absence of other substantive defenses, could enforce payment even though he is not a holder in due course.<sup>21</sup> Recovery by the holder on the check acts to discharge the drawer's liability to the indorser.<sup>22</sup> Therefore the only way that the indorser can obtain satisfaction is to bring a suit against the holder on the contractual obligation between them. Since the indorser must bring suit on the contractual obligation to obtain recovery in this case, he should have paid on the check in the first place and sued the holder on the contract. If the indorser had done so the litigation between the holder and the drawer would have been avoided while the end result would have remained the same.

If the consideration between the drawer and the indorser had failed in the second hypothetical, everything else remaining the same, the drawer would have a viable defense of lack of consideration and under section 3-408 he would be able to plead this defense against the holder's suit on the check. By showing that the defense of failure of consideration exists, the drawer forces the holder to prove that he is a holder in due course.<sup>23</sup> Since he did not give the indorser value for the check, the holder would not be able to main-

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<sup>20</sup> See U.C.C. §§ 3-302(1)(a), 3-303(a).

<sup>21</sup> See U.C.C. § 3-301.

<sup>22</sup> See U.C.C. § 3-603(1).

<sup>23</sup> U.C.C. § 3-307(3).

tain the burden of proof and would therefore be subject to the drawer's defense of failure of consideration and the drawer would avoid liability on the check.

In this type of situation, the application of section 3-408 is an expedient solution because it brings about a quick settlement among the parties of their various interrelated claims. Therefore, the drawer should be able to make use of the provisions of section 3-408, even though the parties to the suit have not dealt with each other, where he does have a defense of failure of consideration.

There are two remaining methods of recovery open to the holder in the second hypothetical situation, and these are both suits against the indorser, one on the underlying obligation and the other on the check. Although suit on the underlying obligation does not involve the application of section 3-408, it is noteworthy as an alternative course for the holder. Such a suit would be for payment on the contract for the auto repairs provided by the holder. The hypothetical stated, however, that these repairs were defective. As such, they fail as consideration. Since this is a simple action on a contract, it is subject to the defense of failure of consideration, and the holder would in all likelihood lose the case.<sup>24</sup>

The holder has the one remaining possibility of bringing a suit on the contract of indorsement under the provisions of section 3-414 of the Code. Section 3-414 provides for the liability of indorsers in suits on the check. Like section 3-413 covering the liabilities of drawers of checks, section 3-414 is cast in absolute language, on its face admitting of no substantive defenses.<sup>25</sup> Once the holder has complied with the procedural requirements of section 3-414,<sup>26</sup> the section indicates that the holder need only prove that the indorser did not indorse the instrument "without recourse" to obtain automatic recovery.<sup>27</sup>

<sup>24</sup> See, e.g., *Bliss v. California Cooperative Producers*, 30 Cal. 2d 240, 181 P.2d 369 (1947); *Perrine v. Pennroad Corp.*, 29 Del. Ch. 423, 51 A.2d 327 (Ch. 1947); *National Sur. Co. v. Larson*, 121 Neb. 395, 237 N.W. 302 (1931); *Selected Inv. Corp. v. Lester*, 327 P.2d 668 (Okla. 1958) holding that failure of consideration is a defense to a contract action at common law.

<sup>25</sup> U.C.C. § 3-414(1) reads:

Unless the indorsement otherwise specifies (as by such words as "without recourse") every indorser engages that upon dishonor and any necessary notice of dishonor and protest he will pay the instrument according to its tenor at the time of his indorsement to the holder or to any subsequent indorser who takes it up, even though the indorser who takes it up was not obligated to do so.

<sup>26</sup> Before section 3-414 imposes liability, the holder must give the indorser notice of dishonor and protest where necessary (§ 3-414). This notice is required in most cases involving an indorser (§ 3-501(2)(a)). In the hypothetical situation, however, the requirements of dishonor and protest are excused because the indorser knew or had reason to know of the dishonor (§ 3-511(2)(b)). Failure to comply with the requirements of notice of dishonor and protest discharges the indorser's liability on the check (§3-502(1)(a)) and also on the underlying obligation (§ 3-802(1)(b)). This last provision of the Code, section 3-802, has led to controversy. (See *Rothschild*, *The Uniform Commercial Code's Undoing of an Obligation*, 7 B.C. Ind. & Com. L. Rev. 63 (1965)). It seems unfair that an indorser, whose position would not be materially altered by a late presentment of notice of dishonor, should escape liability on the check and especially on the underlying obligation.

<sup>27</sup> See U.C.C. § 3-414. If the indorser had indorsed the instrument without recourse

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This automatic recovery seems to be unjust at first glance. The repairs performed by the holder as consideration for receiving the check were defective, and yet the indorser has no opportunity to set out this fact as a defense to payment on the check. He is forced to pay on the check despite the fact that the consideration which he received for the check was defective. In order to avoid this result, it would appear logical to apply section 3-408 as was done regarding the drawer's liability in the first hypothetical situation.

Application of section 3-408 would give the indorser the defense of failure of consideration in the action on the check. In this action, as in the suit against the drawer in the first hypothetical, the parties dealt with one another and so value and consideration would be equivalent. Therefore, as in that earlier suit against the drawer, the indorser need only show that there is a viable defense of lack of or failure of consideration and the holder must then prove that he is a holder in due course.<sup>28</sup> Since the consideration was defective, however, he did not give value, and he will not be able, therefore, to sustain a claim of being a holder in due course.<sup>29</sup> This inability on the part of the holder to maintain that he is a holder in due course would subject him under section 3-408 to the defense of failure of consideration and give the indorser a defense to payment on the check.

In the second hypothetical situation, allowing the application of section 3-408 seems to lead to the most desirable result. But the question remains whether section 3-414 is meant to exclude, by its absolute language, this defense. As pointed out above, the Code is equally as absolute in its tenor in the section dealing with the liability of a drawer on a check as it is in section 3-414.<sup>30</sup> Yet, the provisions of section 3-408 are applied to the section on a drawer's liability. Since there is no difference in the tenor of the language used in the two sections, and since section 3-408 is held applicable in a suit against a drawer, it appears logical to apply it in a suit against an indorser as well. Although its application appears entirely logical, there still remains the question whether the draftsmen of the Code intended that the application of section 3-414 should preclude the assertion of section 3-408 as a defense. The answer would seem to be that the draftsmen did not intend that section 3-408 should apply in suits under section 3-414. In Comment 1 to section 3-414, the draftsmen state, "[A]ll indorsers incur this liability, without regard to whether or not the indorser transferred the instrument for value or received consideration for his indorsement."<sup>31</sup> This view directly contradicts the application of section 3-408. Although this prohibition of section 3-408 seems illogical, there are practical reasons for not allowing indorsers to raise

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he would have in effect disclaimed liability on the check, and the indorser would not therefore be able to recover against him on the check. See, e.g., *Fenold v. Green*, 175 F.2d 247, 249 (2d Cir. 1949).

<sup>28</sup> See U.C.C. § 3-307(3).

<sup>29</sup> See U.C.C. §§ 3-302(1)(a); 3-303(a).

<sup>30</sup> U.C.C. § 3-413(2) reads:

The drawer engages that upon dishonor of the draft and any necessary notice of dishonor or protest he will pay the amount of the draft to the holder or to any indorser who takes it up. The drawer may disclaim this liability by drawing without recourse.

<sup>31</sup> U.C.C. § 3-414, Comment 1.

the defense of failure of consideration under section 3-408. These reasons are perhaps best demonstrated in multi-party transactions. Consider the situation where the indorser has received the check from another indorser, rather than from the drawer. In this type of situation, there could be any number of indorsers between the drawer and the final indorser.

The holder in this multi-party situation has a choice of suing the drawer of the check or any one of the indorsers on the check, and the final indorser on the underlying contract. If, as in the other hypotheticals, the repairs rendered by the holder were defective, the holder would not choose to sue the final indorser on the underlying contract, as he would lose that case because of the defense of failure of consideration.<sup>32</sup> Likewise, if the final indorser could raise section 3-408, the holder would be subject again to the defense of failure of consideration in a suit on the check. The holder would in all likelihood, to avoid the defense of failure of consideration, bring an action on the check against the drawer or one of the intermediate indorsers. Even though he was not a holder in due course, the holder would be likely to prevail in these actions as the parties might not have any substantive defenses available to them. A recovery against the drawer or one of these intermediate parties discharges that party's liability on the check. Ultimately, therefore, the final indorser, in order to recover the money he had transferred to the holder through the indorsement of the check, would have to bring an action on the underlying obligation against the holder.

By making the indorser absolutely liable on the check, as the Comment to section 3-414 indicates the draftsmen of the Code intended to do, this multiple litigation can be effectively limited. This absolute liability would force the indorser to pay the amount due on the check and would discourage any attempt to have payment stopped on the check. The final indorser could then proceed to sue the holder on the underlying obligation. This procedure eliminates the need for the holder to sue the intermediate parties to obtain recovery, and still allows for the adjudication of any valid claim on the part of the final indorser. To allow any other treatment of the problem would result in long chains of needless litigation. Imposing strict liability on the indorser discourages suit by the holder against the intermediate parties and encourages the final indorser to pay on the check and litigate the contract issue and thus keeps litigation to a minimum.

One court, however, has taken the opposite view. In the case of *Brotherton v. McWaters*,<sup>33</sup> the court did apply section 3-408 in a suit against an indorser on a check. The defendant gave the plaintiff an indorsed check in payment for repairs made on the defendant's truck. When these repairs turned out to be defective, the defendant sought the right to defend against the action on the check on the grounds of failure of consideration. The *Brotherton* court held not only that section 3-408 was applicable in a suit against an indorser but also that since the parties had dealt with one another the holder was not immune to the defense of failure of consideration "even assuming they were holders in due course."<sup>34</sup> This second conclusion is con-

<sup>32</sup> See note 24 supra.

<sup>33</sup> 438 P.2d 1 (Okla. 1968).

<sup>34</sup> Id. at 4.



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fusing and unnecessary, and is indicative of the interpretive problems which arise in the consideration of the provisions of Article 3. If the court applies section 3-408 and the parties have dealt with one another, the holder cannot be a holder in due course unless he has given the indorser consideration (value) for the indorsement. In the *Brotherton* case, the holder did not give value and hence is not a holder in due course. Therefore the statement "even if he is a holder in due course" is superfluous.

A result such as the one in *Brotherton* encourages the holder to seek recovery against intermediate parties because they are less likely to have a clear-cut defense such as the final indorser would have here. This result, as pointed out earlier, leads to unnecessary litigation, and as a result impairs the free negotiability of commercial paper by introducing a degree of uncertainty of liability into these transactions.

Because of the excess litigation and the consequent uncertainty of liability, it appears that the type of absolute liability suggested indirectly by the draftsmen in the Comment to section 3-414 is necessary. It is submitted, however, that in order to prevent ambiguity the Comment to section 3-414 should be revised to make explicit the fact that this liability is intended to be absolute and that section 3-408 does not apply. In addition, the Comment to section 3-408 should be rewritten to explain under what circumstances and to whom the defense of want or failure of consideration is available. By these slight changes the interpretive problems, which arose in *Brotherton* and which are likely to arise in the future, may be anticipated and eliminated and the defense of want or failure of consideration may be consistently and equitably applied.

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