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How Can a Bank Become a Holder and Give Value in Order to Attain Holder in Due Course Status?

Alan Richard Atkins

UNIFORM COMMERCIAL CODE COMMENTARY

Commercial Banking—How Can a Bank Become a Holder and Give Value in Order to Attain Holder in Due Course Status?—*Bowling Green, Inc. v. State Street Bank & Trust Co.*—When a non-banking entity seeks to establish its status as a holder in due course, the Uniform Commercial Code[1] requires compliance with the conditions of section 3-302(1).[2] The Code specifically exempts commercial banking institutions from full compliance with section 3-302(1).[3] In view of the special privileges[4] accorded a holder in due course, the question arises whether there is any reason for relaxing these requirements when the claimant is a large commercial bank. More specifically, do the complexity[5] and magnitude[6] of modern commercial banking warrant modification of some of the provisions of Articles Three and Four in the light of commercial reality or the original intentions of the parties to a controversy?

In *Bowling Green, Inc. v. State Street Bank & Trust Co.*,[7] the Court of Appeals for the First Circuit confronted these broad issues in the specific context of the manner in which a bank may achieve holder in due course status. It is the purpose of this note to demonstrate that the court misinterpreted and misapplied the Uniform Commercial Code in resolving the holder in due course issues presented in *Bowling Green.*

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[1] All Uniform Commercial Code citations are to the 1962 Official Text.

[2] U.C.C. § 3-302(1) provides:

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.

[3] U.C.C. § 3-302(1)(a) requires value be given and U.C.C. § 3-303 defines what constitutes the giving of value for Article 3 purposes. U.C.C. §§ 4-208 and 4-209 provide an expanded definition of value, applicable only to banks: a bank has given value to the extent that it has obtained a security interest in the instrument. The text of §§ 4-208 and 4-209 are printed at notes 14 and 15 infra.

[4] Section 3-305 of the U.C.C. provides that a holder in due course takes an instrument free from all claims to it on the part of any person, and all defenses of any party with whom the holder has not dealt, with the exception of certain real defenses.

[5] The Comment to § 4-101 states that the provisions of this Article are consistent with the recognized complexity of modern banking.

[6] The New York Law Revision Commission Reports indicate that the Chase-Manhattan Bank, in a single year, collected and paid through clearings over 247,700,000 checks whose approximate value was 164 billion dollars. 1 New York Law Revision Commission Reports, Study of the Uniform Commercial Code 199 (1954).

[7] 425 F.2d 81 (1st Cir. 1970). The trial court opinion is reported in 307 F. Supp. 648 (D. Mass. 1969).

Bowling Green entered into a conditional sales contract with the Bowl-Mor Company under which Bowling Green agreed to purchase automatic candlepin setting equipment. On September 26, 1966, Bowling Green, in payment of the first of three installments, negotiated a check to Bowl-Mor in the amount of $15,306.[8] The check was given to Bowling Green by the Small Business Administration pursuant to a loan agreement. It was drawn on the United States Treasury by the Small Business Administration. On the morning of the next day, September 27, 1966, Bowl-Mor deposited the check in its checking account at the State Street Bank & Trust Co. The check was not endorsed by Bowl-Mor, but, in accordance with accepted banking procedure authorized under section 4-205,[9] the Bank filled in the necessary endorsement and immediately applied the funds to Bowl-Mor's checking account. Prior to this deposit, Bowl-Mor had an overdraft in its checking account in the amount of $5,024.85. A credit from the Bank, traceable to the check, removed the overdraft and the account was credited with $10,047.54.[10]

On the afternoon of September 26th, Bowl-Mor petitioned for reorganization under Chapter X of the Bankruptcy Act. Later in the day, the Bank, when advised of the petition, transferred the $10,047.54 remaining in Bowl-Mor's checking account to a loan account which Bowl-Mor had at the Bank. Bowl-Mor was indebted to the Bank because of a series of short-term loans which the Bank had made to it during previous months. Under the terms of these loans, the Bank acquired a security interest in Bowl-Mor's products, after-acquired property, and in the proceeds of its chattel paper. The check in question, representing payment for goods sold under a contract of sale, constituted such proceeds.[11]

At the request of the receiver appointed under Chapter X, the Bank, on September 29, 1966, withdrew the $10,047.54 from the loan account and credited it to the checking account. Six days later, the Chapter X petition was dismissed and the Bank again transferred the money to the loan account. Bowl-Mor's financial problems came to a head on February 15, 1967, when it was adjudged bankrupt. During the period from September 26, 1966 to February 15, 1967, Bowl-Mor did not deliver any equipment under its contract with Bowling Green nor did it return any money to Bowling Green. Bowling Green initiated

[8] The check was not introduced into evidence. 307 F. Supp. at 653.

[9] U.C.C. § 4-205(1), provides:

A depositary bank which has taken an item for collection may supply any endorsement of the customer which is necessary to title unless the item contains the words "payee's endorsement required" or the like. In the absence of such a requirement a statement placed on the item by the depositary bank to the effect that the item was deposited by a customer or credited to his account is effective as the customer's endorsement.

[10] The remainder of the original deposit, $233.61, was transferred by State Street to another account which Bowl-Mor maintained at the Bank. This amount was not in issue. 425 F.2d at 82.

[11] The definition of proceeds may be found in U.C.C. § 9-306(1). Chattel paper is defined in U.C.C. § 9-105(1)(b).

an action in federal district court[12] claiming that the Bank held the proceeds of the check impressed with a constructive trust in plaintiff's favor.[13] The district court found that the Bank was a holder in due course and was entitled to the proceeds of the check.

The two important issues which faced the court in *Bowling Green* were, first, whether the Bank had to establish that it was a holder of the item in order to achieve holder in due course status, and second, whether the Bank gave "value," within the meaning of section 4-208,[14] when it received the check. The court of appeals HELD: "A bank which takes an item for collection from a customer who was himself a holder need not establish that it took the item by negotiation in order to satisfy 4-209."[15] The court further held that the Bank's pre-existing security interest, as defined by section 1-201(37),[16] in the proceeds of Bowl-Mor's chattel paper, was sufficient to constitute the value required by section 3-302.

In order for the Bank to take the instrument free from Bowling Green's personal claims against Bowl-Mor, the Bank had to establish its status as a holder in due course.[17] Both the official text of section

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[12] The basis of federal jurisdiction was diversity of citizenship.

[13] Bowling Green wanted to have State Street declared a constructive trustee of the money deposited in Bowl-Mor's account. It argued that "Bowl-Mor knew it could not perform at the time it accepted payment, that the Bank was aware of this fraudulent conduct and that the Bank, therefore, received Bowl-Mor's deposit impressed with a constructive trust in plaintiff's favor." 425 F.2d at 83.

The Court of Appeals affirmed the district court's finding that State Street acted in good faith when it received the check. The court applied the subjective test, not the objective test as contended for by Bowling Green. The subjective test is embodied in U.C.C. § 1-201(19). Accord, Pazol v. Citizens Nat'l Bank, 110 Ga. App. 319, 138 S.E.2d 442 (1964); Citizens Nat'l Bank v. Ft. Lee Sav. & Loan Ass'n, 89 N.J. Super. 43, 213 A.2d 315 (1965); Citizens Bank of Booneville v. National Bank of Commerce, 334 F.2d 257 (10th Cir. 1964). See also Farnsworth, Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code, 30 U. Chi. L. Rev. 666 (1963); 1 New York Law Revision Commission Reports, Study of the Uniform Commercial Code at 203-06, 213-43, 424-26, 518-31.

[14] U.C.C. § 4-208(1) provides:

> A bank has a security interest in an item and any accompanying documents or the proceeds of either
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> (a) in case of an item deposited in an account to the extent to which credit given for the item has been withdrawn or applied;
>
> (b) in case of an item for which it has given credit available for withdrawal as of right, to the extent of the credit given whether or not the credit is drawn upon and whether or not there is a right of charge-back; or
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> (c) if it makes an advance on or against the item.

[15] 425 F.2d at 84. U.C.C. § 4-209 provides:

> For purposes of determining its status as a holder in due course, the bank has given value to the extent that it has a security interest in an item provided that the bank otherwise complies with the requirements of Section 3-302 on what constitutes a holder in due course.

The provisions of this section are not, as the court indicates, in and of themselves susceptible of being satisfied by the bank.

[16] U.C.C. § 1-201(37), provides in part that "'security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation."

[17] The rights of a holder in due course are set forth in note 4 supra. U.C.C. § 3-306

3-302(1),[18] ("(a) holder in due course is a holder who takes the instrument . . ."), and the great weight of authority[19] make clear the proposition that a party must be a holder before he can become a holder in due course.

"Holder" status can be attained only through the process of negotiation. An instrument, such as the check in this case, which is payable to the order of a named individual, can be negotiated only by delivery and endorsement by the transferee.[20] When negotiation occurs, then, under the definition of "holder" in section 1-201(20),[21] the transferee becomes a "holder."

The court stated that since there was no evidence that Bowl-Mor endorsed the check, it could not determine whether the Bank became a holder under section 1-201(20).[22] The court, however, did not regard this lack of endorsement as conclusive on the holder issue which it phrased in these terms: "whether [the Bank] must establish that it took the item in question by endorsement in order to meet its burden."[23] The court then reasoned that since the Bank's depositor was a holder,[24] the Bank, under the provisions of section 3-201(1),[25] by acquiring all of the rights of its transferor, became a holder. The court's analysis and application of section 3-201(1) is open to serious

correspondingly provides that one who is not a holder in due course takes an instrument subject "to all valid claims to it on the part of any person."

[18] The text of § 3-302(1) is set forth in note 2 supra.

[19] See W. Willier & F. Hart, 1 Forms & Procedures Under the U.C.C. § 34.06(2) (1969) [hereinafter cited as Willier & Hart]: "The first requisite of a holder in due course is that he be a holder." See also Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962); Citizens Nat'l Bank v. Ft. Lee Sav. & Loan Ass'n, 89 N.J. Super. 43, 213 A.2d 315 (1965); Pazol v. Citizens Nat'l Bank, 110 Ga. App. 319, 138 S.E.2d 442 (1964): Dluge v. Robinson, 204 Pa. Super. 404, 204 A.2d 279 (1964). W. Hawkland, Commercial Paper & Bank Deposits and Collections at 183 (1967); White, Some Petty Complaints About Article 3, 65 Mich. L. Rev. 1315 (1967); Mellinkoff, The Language of the Uniform Commercial Code, 77 Yale L.J. 185 (1967); 2 New York Law Revision Commission Reports, Study of the Uniform Commercial Code at 1325.

[20] U.C.C. § 3-202(1) provides:

> Negotiation is the transfer of an instrument in such form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with any necessary endorsement; if payable to bearer it is negotiated by delivery.

[21] In U.C.C. § 1-201(20), "Holder" is defined as: "a person who is in possession of a document of title or an instrument or an investment security drawn, issued or endorsed to him or to his order or to bearer or in blank."

[22] 425 F.2d at 83.

[23] Id. at 84.

[24] The facts indicate that Bowling Green endorsed and delivered the check to Bowl-Mor, Id. at 83. Under U.C.C. § 1-201(20) Bowl-Mor therefore became a holder of the check.

[25] U.C.C. § 3-201(1) provides:

> Transfer of an instrument vests in the transferee such rights as the transferor has therein, except that a transferee who has himself been a party to any fraud or illegality affecting the instrument or who as a prior holder had notice of a defense or claim against it cannot improve his position by taking from a later holder in due course.

question. This section recognizes the concept that a transferee of an instrument takes by the transfer all of the rights of his transferor. If these rights also include the right to become a holder even though a necessary endorsement was missing, which is what the court seems to suggest, there would be no difference between transfer and negotiation. One would not need to take by negotiation to become a holder. That such a meaningful difference does exist is evident from the fact that the Uniform Commercial Code has provided a separate section on negotiation,[26] and has authorized a transferee to demand the endorsement of his transferor.[27]

In sections 1-201(20) and 3-202(1), the Code expressly provides that a person may only become a holder if the instrument is taken by negotiation; no other method of attaining holder status is provided.[28] The distinction between transfer and negotiation is further emphasized by the fact that if the instrument is merely the subject of a transfer, Article Three has limited application, while if it is negotiated, Article Three governs the rights and liabilities of the parties.[29] To accentuate the necessity of negotiation, section 3-201(3) gives the transferee the unqualified right to the endorsement of his transferor. This allows the transferee to compel negotiation and become a holder in his own right. The rationale of the court's decision renders these sections of the Code superfluous. The rights referred to in section 3-201(1) may not be the same as those which are granted to a holder under Articles Three and Four.[30] The rights acquired by the transfer considered in section 3-201(1) may not amount to title, while if the instrument is negotiated, title passes.[31] In order for a transferee to become a holder, with the rights accorded a holder, he must get the endorsement of his transferor and thereby complete negotiation.[32] The Bank did not, then, obtain the rights of a holder merely by the transfer; in order to obtain

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[26] U.C.C. § 3-202(1). The text of this section is printed at note 20 supra.

[27] U.C.C. § 3-201(3).

[28] Further support for the proposition that a transferee needs the endorsement of his transferor if he is to become a holder may be found in 2 New York Law Revision Commission Reports, Study of the Uniform Commercial Code at 849, where it is stated: "[a] negotiable instrument may be the subject of a gift . . . and the gift of an instrument, if it is properly endorsed, will constitute a negotiation making the donee a holder. . . ." See also Id. at 850-51. In Koreska v. United Cargo Corp., 23 App. Div. 2d 37, 258 N.Y.S.2d 432 (1965) it was held that a transferee of a negotiable bill of lading was not a holder under § 1-201(20) since there was no showing that the bill was endorsed by the transferor.

[29] Willier & Hart, supra note 19, at § 34.02.

[30] See Jett v. Atlanta Fed. Sav. & Loan Ass'n, 104 Ga. App. 688, 123 S.E.2d 27 (1961), and Dluge v. Robinson, 204 Pa. Super. 404, 204 A.2d 279 (1964). In *Dluge*, the court held that plaintiff could not maintain an action under U.C.C. § 3-804 since he was not a holder, but a transferee. See also E.F. Hutton & Co. v. Manufacturers Nat'l Bank, 259 F. Supp. 513 (E.D. Mich. 1966).

[31] U.C.C. § 3-201, Comment 1.

[32] U.C.C. §§ 3-201(1) and 3-201(3). In Woodhouse, Drake & Carey, Ltd. v. Anderson, 61 Misc. 951, 307 N.Y.S.2d 113 (1970), the court, relying on U.C.C. § 3-201(3), held that the plaintiff was a holder in due course despite the fact that the note was endorsed after a prior transfer.

these rights it had to obtain Bowl-Mor's endorsement. A contrary conclusion would not be consonant with the provisions of Article Three.

To strengthen its conclusion that the Bank need not take by negotiation and need not establish that it is a holder, the court expressed doubt that the concept of holder, as expressed in section 1-201(20),[33] applied to Article Four with full force.[34] To support this proposition the court cited section 4-201(1)[35] which states that the lack of an endorsement does not affect a bank's status as the depositor's agent for purpose of collection, and section 4-205,[36] which permits a bank to supply a depositor's missing endorsement. Finally, the court stated that it did not consider the concept of holder relevant to Article Four because section 4-209[37] applies only to good faith, value and notice, and not to holder status, "a status which section 3-302 assumes rather than requires."[38]

A bank's right to be a holder in due course is expressly recognized in section 4-209.[39] Section 4-209 provides that a bank, in order to achieve holder in due course status, must fully comply with section 3-302, with the exception that a bank may also give value in the manner set forth in section 4-209. Therefore, the requirement of section 3-302 that a holder in due course must be a holder is a requirement under section 4-209.[40] That section 3-302 "assumes" holder status does not mean that it is not required by the section. In fact, the court's "assumption" argument amounts to little more than a play on words.

The recognition in section 4-201(1) of the *prima facie* agency status of a collecting bank is consistent with prevailing law and prac-

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[33] The text of U.C.C. § 1-201(20) is printed at note 21 supra.

[34] 425 F.2d at 84.

[35] U.C.C. § 4-201(1) provides:

> Unless a contrary intent clearly appears and prior to the time that a settlement given by a collecting bank for an item is or becomes final (subsection (3) of Section 4-211 and Sections 4-212 and 4-213) the bank is an agent or sub-agent of the owner of the item and any settlement given for the item is provisional. This provision applies regardless of the form of endorsement or lack of endorsement and even though credit given for the item is subject to immediate withdrawal as of right or is in fact withdrawn; but the continuance of ownership of an item by its owner and any rights of the owner to proceeds of the item are subject to rights of a collecting bank such as those resulting from outstanding advances on the item and valid rights of setoff. When an item is handled by banks for purposes of presentment, payment and collection, the relevant provisions of this Article apply even though action of parties clearly establishes that a particular bank has purchased the item and is the owner of it.

[36] The text of U.C.C. § 4-205 is printed at note 9 supra.

[37] The text of U.C.C. § 4-209 is printed at note 15 supra.

[38] 425 F.2d at 84.

[39] The text of U.C.C. § 4-209 is printed at note 15 supra.

[40] U.C.C. § 4-102 provides that where the terms of Article 4 are in conflict with those of Article 3, the provisions of Article 4 are to govern. Since there is no conflict between § 3-302 and § 4-209, the provisions of § 3-302 must be complied with by a bank attempting to attain the status of holder in due course, including the requirement that it be a holder.

tice.[41] When a check is deposited for collection, ownership of the item remains in the depositor and, while it is an agent, the bank is not subject to liabilities which might be imposed upon the owner.[42] Section 4-201(1) indicates that a depositary bank is the agent of its depositor whether or not the instrument is endorsed. The court drew on this section to argue that the concept of holder is not applicable to Article Four. But section 4-201(2) plainly recognizes that a bank becomes a holder when an item is endorsed.[43] To reason from the fact that a bank is its depositor's agent for purposes of collection of an item despite the lack of an endorsement, to the conclusion that a bank need not take by negotiation in order to be a holder in due course, is not a proper interpretation of the section. Section 4-201 recognizes the distinction between a bank's position as the collecting agent of its depositor and its position as a holder of the item. The latter concept is not subsumed by the former.[44]

The court's reference to the ability of a bank to supply a missing endorsement[45] as an indication that "the concept of holder as defined in section 1-201(20) does not apply with full force to Article 4" is similarly unsound.[46] A contrary implication should be drawn: the right recognized under section 4-205(1) is an indication of the importance of a bank taking by negotiation and thereby becoming a holder.

The court could have, by properly applying the Code, reached the result that the Bank was a holder. Under section 3-202(1) delivery and endorsement of order paper constitute negotiation and the realization of holder status. Section 4-205(1), in order to permit items to move more rapidly through banking channels,[47] allows a depositary bank to supply the missing endorsement of a depositor so long as there are no accompanying restrictions.[48] This relieves a bank of the necessity of returning items for endorsement, a formidable task in light of the number of checks received daily by banks. The effect of this section is, therefore, not to limit the effects of holder status in Article Four, but to recognize the necessity of holder status, and to give banks

[41] U.C.C. § 4-201, Comment 3.

[42] U.C.C. § 4-201, Comment 4.

[43] U.C.C. § 4-201(2) provides: "[a]fter an item has been endorsed with the words 'pay any bank' or the like, only a bank may acquire the rights of a holder. . . ." See 1 Willier & Hart, supra note 19, at § 43.02, and 2 New York Law Revision Commission Reports, Study of the Uniform Commercial Code at 1286. See also Investment Serv. Co. v. Martin Bros. Container & Timber Prod. Corp.,—Ore.—, 465 P.2d 868 (1970), where the Supreme Court of Oregon held that a depositary bank becomes a holder when, under U.C.C. § 4-205, it supplies its depositor's endorsement.

[44] See Pazol v. Citizens Nat'l Bank, 110 Ga. App. 319, 138 S.E.2d 442 (1964); Funk, Banks and the Uniform Commercial Code 134 (1964); Russell, Article 4: Bank Deposits and Collections, 29 Mo. L. Rev. 411 (1964).

[45] U.C.C. § 4-205(1). The text of this section is printed at note 9 supra.

[46] 425 F.2d at 84. The text of U.C.C. § 1-201(20) is printed at note 21 supra. See Investment Serv. Co. v. Martin Bros. & Container & Timber Prod. Co.,—— Ore. ——, 465 P.2d 868 (1970).

[47] U.C.C. § 4-205, Comment 2.

[48] U.C.C. § 3-205 specifies when an endorsement is restrictive.

another method of obtaining the necessary endorsement. This section should be construed as emphasizing the importance of the holder concept in Article Four.

In light of the caveat in section 4-205(1) that the bank's right to provide the endorsement is subject to restrictions that may appear on the check, it is important to note that the check in the instant case was not introduced into evidence. The check was issued by the Small Business Administration and was drawn on the U.S. Treasury.[49] Treasury checks usually have restrictions on the reverse side covering the endorsements. One commentator has argued that "a bank would not be authorized to supply the payee's endorsement on a check by the United States Government since Treasury regulations customarily require the payee's endorsement on government checks, even where such checks themselves bear no legend requiring endorsement."[50] The facts of the case indicate that Bowling Green was the named payee on the check. Since the Bank's depositor, Bowl-Mor, was not a payee, the Treasury restrictions would not have been applicable and the Bank would have been free, under section 4-205(1), to supply Bowl-Mor's endorsement. The Bank would therefore have qualified as a holder under section 1-201(20). If the court had determined that the Bank was a holder, it would have avoided its untenable conclusion that the Bank need not take by negotiation in order to be a holder in due course. Delivery and endorsement need not, in order to complete negotiation, occur simultaneously. The endorsement authorized under section 4-205(1) is equivalent to the depositor's endorsement by his own hand.

Neither the fact that section 4-201(1) recognizes a bank's agency status, despite lack of endorsement, or that section 4-205(1) permits the bank to supply a missing endorsement, leads to the conclusion that the concept of holder is not required by Article Four as a prerequisite to a bank achieving holder in due course status. Further, the fact that an item is transferred from a person qualifying as a holder does not, under section 3-201(1), warrant the conclusion that the transferee thereby becomes a holder. The court should have concluded that in order for the Bank to become a holder, it had to acquire the check by negotiation.[51] The court's decision that the Bank need not take by negotiation in order to achieve holder status rests upon a misapplication of the governing Code sections in an effort by the court to achieve a result it believed was intended by the parties.[52]

The second problem facing the Bank in establishing its status as a holder in due course was proving it gave value for the check. No problem was presented as to whether the Bank gave value for that

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[49] 307 F. Supp. at 650.

[50] H. Bailey, Brady on Bank Checks, § 8.10 (1969). See also J. Clarke, H. Bailey & R. Young, Bank Deposits & Collections 59 (1963).

[51] U.C.C. § 3-201, Comment 7 provides: "there is no effective negotiation until the endorsement is made. Until that time the purchaser does not become a holder. . . ."

[52] See excerpt from the court's opinion, note 70 infra.

portion of the check ($5,024.84) which was immediately applied to Bowl-Mor's overdraft. Crediting the overdraft constitutes the giving of value as defined in section 3-303(b),[53] which states that a holder gives value when an amount is taken in payment of an antecedent debt.[54] As to whether the Bank had given value for the remaining $10,047.54, the court of appeals held that it was crucial that this be determined as of the time the Bank received the check for deposit, not at the time it initially credited Bowl-Mor's loan account.[55]

In finding that the Bank did give value, the court relied on section 4-209 which states that a bank has given value to the extent that it has a security interest in the item. The court reasoned that since the Bank had a pre-existing security interest in the proceeds of Bowl-Mor's chattel paper, and since the check represented such proceeds, the Bank had given value for the remaining $10,047.54. The court used the general definition of security interest found in section 1-201(37),[56] and stated that there is no evidence that the term "security interest" is used in a narrower sense in section 4-209. The court then pointed out that both section 3-303 and the official comment to section 4-209 provide that a holder gives value when he takes an instrument in payment for an antecedent debt. The court then concluded that the Bank had given value, not because it had a security interest under section 4-208,[57] but because of its pre-existing security interest in Bowl-Mor's chattel paper and proceeds. The pre-existing interest alone, without application of the check to it, was sufficient, in the court's view, to constitute the giving of value. The fact that this security interest was not created under Article Four, the fact that the Bank did not, upon receipt of the check, apply it to the pre-existing obligation, and the fact that the Bank received the check in the capacity of a depositary-collecting bank and not as a secured creditor, did not influence the court's conclusion that a security interest is a security interest however acquired. The purpose of this section of the note is

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[53] U.C.C. § 3-303 provides:

A holder takes the instrument for value

(a) to the extent that the agreed consideration has been performed or that he acquires a security interest in or a lien on the instrument otherwise than by legal process; or

(b) when he takes the instrument in payment of or as security for an antecedent claim against any person whether or not the claim is due; or

(c) when he gives a negotiable instrument for it or makes an irrevocable commitment to a third person.

[54] See Citizens Bank of Booneville v. National Bank of Commerce, 334 F.2d 257, 261 (10th Cir. 1964).

[55] The court reasoned that "[t]he Bank may well have given value under § 4-208(1)(a) when it credited the balance of Bowl-Mor's checking account against its outstanding indebtedness. But by that time the Bank knew of Bowl-Mor's petition for reorganization. . . ." 425 F.2d at 86. If the question of value was considered from the date the Bank credited the loan account, serious questions of its good faith and whether it had notice of a claim would have arisen.

[56] A portion of the text of § 1-201(37) is printed at note 16 supra.

[57] The text of § 4-208(1) is printed at note 14 supra.

to show that there is a difference between the two types of security interests, and that the court's interpretation of section 4-209 is erroneous.

Depositary banks[58] taking items for collection are granted holder in due course status as a means of protection. In a typical situation a check is drawn on another bank, the payor bank,[59] by a third party. The payee takes the check to his bank and deposits the item in his checking account. The depositary bank credits the account in the amount of the check and forwards the item for collection. The credit given the depositor is provisional[60] and remains provisional until final settlement[61] is made by the payor bank. Until final settlement, the depositary bank is acting as its depositor's agent[62] for purposes of collection. As a matter of custom, banks allow depositors to draw against checks deposited before final payment is made. In many instances, such withdrawals are made and the check is subsequently dishonored. To reconcile this difficulty, the Code allows the depositary bank to acquire ownership rights in the check only to the extent that it has allowed withdrawals. The legal capacity through which a bank exercises its rights as owner is that of a holder in due course. The bank's rights as a holder in due course exist only insofar as it has allowed a depositor to withdraw, or to the extent that it has allowed the money represented by the check to be used to cancel or diminish a pre-existing debt.[63]

Section 4-209 indicates that a bank has given value to the extent that it has a security interest in the instrument. The official comment states that this section "completes the thought of the previous section." The previous section, 4-208(1), sets forth various situations which will give rise to a security interest in favor of a depositary bank. It should be noted that these security interests are created only for Article Four purposes and are distinct from the more general concept of security interest reflected in section 1-201(37).[64] This latter section makes no reference to Articles Three and Four although several cross references are made to Articles Two and Nine. This construction supports the conclusion that the types of security interests created in section 4-208 are of a limited nature, confined to Article Four, and that those referred to in section 1-201(37) are not meant to expand upon those in Article Four. Thus, only the security interests created by section 4-208 constitute value for purposes of determining whether a depositary bank has given value. Additional support for this view is provided by section 1-201, which indicates that the definitions within that section are subject to additional definitions found in other Articles,

[58] In U.C.C. § 4-105(a) a depositary bank is defined as the "first bank to which an item is transferred for collection. . . ."

[59] In U.C.C. § 4-105(b) a payor bank is defined as "a bank by which an item is payable as drawn."

[60] U.C.C. § 4-201(1). The text of this section is printed at note 35 supra.

[61] U.C.C. § 4-104(1)(j).

[62] U.C.C. § 4-201(1). The text of this section is printed at note 35 supra.

[63] U.C.C. § 3-303. The text of this section is printed at note 53 supra.

[64] The text of § 1-201(37) is printed at note 16 supra.

"unless the context otherwise requires."[65] There is no indication that sections 4-208 or 4-209 do otherwise require and, therefore, the definition of security interest in section 4-208 is controlling. The underlying reasons for giving a bank security interest, and the overall application of the relevant sections of the Code point up the difference between the Bank's pre-existing security interest and the one granted the Bank as its depositor's agent.

Further evidence for the conclusion that the Bank had not given value may be found from an examination of the functional aspects of sections 4-208 and 4-209. Under section 4-208(1), a bank is given a security interest to the extent that it has actually given value. This occurs when credit which has been granted has been actually drawn against, where the credit given may be drawn upon as a matter of right whether or not it is in fact drawn upon, or where the bank makes an advance on or against the item.[66] The requirements of this section are similar to the concepts of value put forth in Article Three.[67] The requirements, basic to each Article, are that "value" is something actually given, or something given in the form of an irrevocable commitment.

Neither section 4-208 nor section 3-303 recognizes that a bank has given value merely because it has a security interest in the proceeds of its depositor's chattel paper. At the time the check is received for deposit, the existence of this security interest, created under Article Nine of the Code, does not satisfy the requirement that value actually be given. If upon receiving the check, the Bank immediately credited the loan account in the amount of $10,047.54, it would have actually given value as required by section 4-208. Instead, the Bank credited the checking account and did not apply the money to the loan account until after it learned of the petition for reorganization. As was pointed out above, the court held that holder in due course status had to be determined at the point in time when the Bank received the check. In situations similar to *Bowling Green*, the courts have decided that a collecting bank acquires a security interest, thereby satisfying the value requirement, when the sums representing checks deposited are immediately applied toward a debt secured by a pre-existing security interest held by the bank. In *New Waterford Bank v. Freeman*,[68] the bank held a depositor's note secured by a chattel mortgage. When the depositor placed $9,942.07 in his checking account, the bank immediately credited the loan account with $6,700, debited the checking

[65] U.C.C. § 1-201, General Definitions, provides that the general definitions here are: "[s]ubject to additional definitions contained in the subsequent Articles of this Act which are applicable to specific Articles or Parts thereof, and unless the context otherwise requires, ..."

[66] The text of U.C.C. § 4-208(1)(a) is printed at note 14 supra. See Peoples Bank of Aurora v. Haar, 421 P.2d 817 (Okla. 1966); Citizens Bank of Boonville v. National Bank of Commerce, 334 F.2d 257 (10th Cir. 1964); Citizens Nat'l Bank v. Ft. Lee Sav. & Loan Ass'n, 89 N.J. Super. 43, 213 A.2d 315 (1965).

[67] See § 3-303. The text of this section is printed at note 53 supra.

[68] 31 Pa. D. & C. 2d 773 (1963).

account, and cancelled the note. The court found that the bank gave value and had a security interest in the check to the extent that it credited the loan account. Like the State Street Bank, the New Waterford Bank had a security interest created by earlier loans to its depositor. In *New Waterford*, however, it was not the existence of this security interest which satisfied the value requirement. Rather, it was the application of the sum represented by the check against the loan account which gave the bank the security interest contemplated by section 4-208. There are, then, two security interests in these cases: one created by a loan and not in and of itself constituting value for holder in due course purposes, and a second created in the bank's favor when it applies money from the check against the prior loan. It is this second security interest which gives rise to value so that the bank can become a holder in due course of the check. Through this procedure the bank acquires an interest in the check which it can exercise in its own name if the check is not honored. Also illustrative of this point is *Citizens National Bank of Booneville v. National Bank of Commerce*.[69] In that case a depositary bank was held to have a security interest in an item presented for collection since it credited the depositor's overdue loan account in the amount of the check. Again, it was not the existence of the security interest created by the loan account which constituted value for holder in due course purposes, but the application of the check to the loan.

Both *New Waterford* and *Citizens National Bank* indicate that when the Bank received the check for deposit it did not acquire the requisite security interest and therefore did not give value. The bank did not, then, attain holder in due course status.

The concluding paragraph of the opinion may better reflect the underlying rationale of the court's decision than an analysis of the court's application of the Code. The court seems to indicate that its holding reflects the true intentions of the parties, and that justice would not be served by allowing these intentions to be avoided through the manipulation of technical provisions of the statute.[70] From this point of view the court's decision may be correct[71] and its holding just.

[69] 334 F.2d 257 (10th Cir. 1964). See also Nicklaus v. Peoples Bank & Trust Co., 258 F. Supp. 482 (E. D. Ark. 1965), where the bank was deemed to have given value when it accepted a check in total satisfaction of a pre-existing debt.

[70] The court observed:

> We see no discrepancy between this result and the realities of commercial life. Each party, of course, chose to do business with an eventually irresponsible third party. The Bank, though perhaps unwise in prolonging its hopes for a prospering customer, nevertheless protected itself through security arrangements as far as possible without hobbling each deposit and withdrawal. Plaintiff, on the other hand, not only placed the initial faith in Bowl-Mor, but later became aware that Bowl-Mor was having difficulties in meeting its payroll. It seems not too unjust that this vestige of caveat emptor survives.

425 F.2d at 87.

[71] Some support for the court's approach may be found in Security Trust & Sav. Bank v. Federal Reserve Bank of Minneapolis, 269 F. Supp. 893 (D. Mont. 1967) where the court held that since no party to the check was damaged because of a missing

The result reached, however, was founded upon a misapplication of relevant Code sections. It is regrettable that neither party to the controversy saw fit to introduce the check into evidence; many questions raised by the case may have been better answered if this had been done.

The court's analysis of the Uniform Commercial Code will do little to further concepts of uniformity and predictability in commercial law. The court has expanded the concept of what constitutes value by not requiring that value actually be given when the check is received. The court further held that a bank seeking the status of a holder in due course need not take by negotiation and therefore need not qualify as a holder. The decision effectively emasculates the concept of holder in due course in that it will allow banks to attain that status without full compliance with the provisions of Articles Three and Four.

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endorsement, the drawee bank would be able to maintain an action. In Nicklaus v. Peoples Bank & Trust Co., 258 F. Supp. 482 (E.D. Ark. 1965), the court held that a bank accepting a check acted in good faith even though it knew that the person tendering the check was insolvent. This would support the court's attitude toward State Street's continued financial assistance to a failing company.