

THE AUTONOMY OF THE BANKER'S OBLIGATION ON BANK DRAFTS AND CERTIFIED CHEQUES

Benjamin Geva*

Toronto

*A bank draft or certified cheque ("banker's instrument") is a negotiable instrument on which a bank is obligated, used by a paying party in payment to a creditor. The issue explored in this article is the autonomy of the banker's obligation on the banker's instrument, namely whether the payee-creditor may enforce it irrespective of the obligated bank's defences against the paying party, as well as of the paying party's defences against the payee-creditor. From a doctrinal point of view, the questions are whether the payee-creditor can be a holder in due course (so as not to be subject to the obligated bank's defences against the paying party), and whether *jus tertii*, that is, a defence based on rights of a third party (here the paying party), is available to the obligated bank against a holder not in due course. This article answers the first question in the affirmative but provides only a partly affirmative answer to the second. The conclusion is thus that as a holder in due course the payee-creditor takes the banker's instrument free from the obligated bank's defences against the paying party. At the same time, as a holder not in due course, the payee-creditor holds the instrument subject to the obligated bank's defences against the paying party; regardless of whether the paying party joins the action of the payee-creditor against the obligated bank, the payee-creditor holds the instrument subject also to the paying party's claim for the specific restitution of the instrument. Contract defences of the paying party against the payee-creditor, other than the retroactive cancellation of their contract leading to such a claim for the restitution of the instrument, are not available to the obligated bank against the payee-creditor. Autonomy is thus not entirely achieved.*

Une traite bancaire ou un chèque certifié («titre bancaire») est un effet de commerce qui engage la responsabilité de la banque et qui est utilisé par un débiteur pour payer son créancier. Cet article étudie le problème de l'autonomie de la responsabilité du banquier en vertu de ce titre bancaire; plus précisément, il examine la question de savoir si le créancier peut en exiger le paiement indépendamment des défenses que la banque pourrait faire valoir vis-à-vis le débiteur et celle des moyens de défense du débiteur vis-à-vis le créancier.

*Sur le plan analytique, il s'agit de déterminer si le créancier peut être un détenteur régulier (et ainsi ne pas être assujéti aux moyens de défense de la banque contre le débiteur) et si un *jus tertii*, c'est-à-dire une défense fondée sur les droits d'un tiers (en l'espèce, le débiteur), peut être invoqué par la banque contre quelqu'un qui n'est pas un détenteur régulier. Cet article répond affirmativement à la première question et apporte à la seconde une réponse qui n'est que partiellement affirmative. Ainsi, comme détenteur régulier, le créancier reçoit le titre bancaire*

*Benjamin Geva, of Osgoode Hall Law School, York University, Toronto, Ontario.

libre des moyens de défense de la banque contre le débiteur. Cependant, si le créancier n'est pas détenteur régulier, son titre bancaire reste assujéti aux moyens de défense de la banque contre le débiteur. Que le débiteur soit ou non partie au recours du créancier contre la banque, le créancier qui détient ce titre bancaire demeure néanmoins exposé à une demande de restitution du titre par le débiteur. La banque ne peut pas invoquer contre le créancier les moyens de défense basés sur le contrat entre le débiteur et le créancier, sauf ceux qui résultent de l'annulation du contrat et qui mènent à la demande de restitution du titre. En conséquence, l'autonomie complète du banquier n'existe pas.

Introduction

A banker's instrument can broadly be described as a payment instrument governed by the Bills of Exchange Act (the "Act")¹ payable on demand, on which a bank or another financial institution ("bank" or "banker") has incurred liability to the holder. It is a mechanism for the transmission of funds between individual as well as corporate debtors and creditors; it facilitates the avoidance of the risk of physical carriage of money as well as gives the creditor the assurance of payment in the form of the banker's credit attached to it.²

In Canada, banker's instruments are either bank drafts or certified cheques. A bank draft is an order to pay a sum of money addressed by a bank either to itself or to another bank.³ A certified cheque is a cheque⁴ drawn by a customer on his or her bank, marked by that bank to show that it is drawn by the person purporting to draw it, that it is drawn upon an existing account with the drawee and that there are sufficient funds to meet it; in fact, upon certification, funds have been withdrawn from the drawer's account and placed in a suspense account in anticipation of the certified cheque being presented for payment.⁵

In practice, a debtor will procure a banker's instrument by either paying over the counter for it, or having his or her bank account debited for the amount. Alternatively, a holder of a cheque may procure its certification at the drawee (debtor's) bank. Either way, the creditor holds an instrument to which a banker's credit is attached.

¹ R.S.C. 1985, c. B-4. The English (United Kingdom or Imperial) Act is the Bills of Exchange Act, 1882 (U.K.), 45 & 46 Vict., c. 61, as am. The term "Anglo Canadian Act" refers to both statutes.

² Banker's instruments (first certified cheques followed by bank drafts) are accorded priority (subject to secured creditors) upon the insolvency of a financial institution. See sect. 31 of the Canadian Payments Association Act, R.S.C. 1985, c. C-21.

³ The bank money order is a species of a bank draft. See B. Geva, *Irrevocability of Bank Drafts, Certified Cheques and Money Orders* (1986), 65 Can. Bar Rev. 107, at p. 113.

⁴ As defined in the Act in sec. 165(1) (Can.); 73 (U.K.).

⁵ Whether the personal money order is a species of personal cheque or of certified cheque is discussed in Geva, *loc. cit.*, footnote 3, at pp. 130-145. Since then, the American UCC has sided with the former view. See Prefatory Note (under "C. Benefits to the Banking to Community") to Rev. (1990), UCC Article 3, and cf. §§ 3-411 and 3-412.

In a previous article,⁶ I examined the irrevocability or binding effect of the banker's engagement on the banker's instrument. I concluded that the banker's obligation is binding towards the holder and is irrevocable.⁷ That is, the bank signatory⁸ to a banker's instrument ("the issuing bank" or "the obligated bank") is liable to the holder either as a drawer⁹ of a bank draft or as an acceptor¹⁰ of a bank draft or certified cheque.¹¹ Nonetheless, whether the banker's obligation is also absolute and autonomous, namely free from the bank's defences against the customer, as well as from the customer's defences against his or her creditor, was left open as an entirely different matter, outside the scope of that article.

The present article takes on where its predecessor stopped. That is, it discusses the autonomy or the absolute nature of the banker's instrument, or more specifically, of the banker's obligation on it. The precise issue is whether the holder can enforce the banker's obligation irrespective of the banker's defences against the customer, as well as of defences available to the customer against the holder.

The following setting is quite typical. A buyer ("paying party") pays the seller ("creditor") by means of a banker's instrument. The obligated bank may attempt to refrain from payment either on the basis of its own defences or of those of the paying party.¹² Upon the dishonour of the instrument, the question is then whether the obligated bank may successfully defend the holder's action on the basis of (i) the bank's own defences against the paying party, as for example where the party has failed to pay for the banker's instrument,¹³ or (ii) the paying party's defences against the creditor, as for example, where the creditor has defrauded the paying party or is in breach of their contract. Related to this latter aspect is the question whether the paying party can enjoin the obligated bank from making payment on the instrument on the basis of the

⁶ *Loc. cit.*, footnote 3.

⁷ The Anglo Canadian Act does not deal with banker's instruments as a specific category. In contrast, Rev. (1990), UCC §§ 3-412 and 3-409 specifically provide for the liability (and hence the irrevocable obligation to the holder) of the issuer of a banker's instrument as well as of the certifying bank.

⁸ For certification as signature, see Geva, *loc. cit.*, footnote 3, at pp. 127-128.

⁹ For the drawer's engagement under the Act, see sec. 129(a) (Can.); 55(1)(a) (U.K.).

¹⁰ For the acceptor's engagement under the Act, see sec. 128(a) (Can.); 54(1) (U.K.).

¹¹ For judicial endorsement of this position with respect to certified cheques, see particularly *A.E. LePage Real Estate Services Ltd. v. Rattray Publications* (1991), 5 O.R. (3d) 216, at p. 218 (Ont. Gen. Div.). See also *Re Maubach and Bank of Nova Scotia* (1987), 62 O.R. (2d) 220, at p. 221 (Ont. C.A.).

¹² Much of the debate in the United States has been confused by placing it under the misleading title of the obligated bank's right to stop payment. See, for example, annotation by S.R. Shapiro, Uniform Commercial Code: Bank's Right to Stop Payment on Its Own Uncertified Check or Money Order (1980), 97 A.L.R. (3d) 714. But the real issue is the availability of defences; this has nothing to do with the right to stop (or countermand) payment on a cheque under sec. 167 (Can.) or 75 (U.K.) of the Act.

¹³ That is, in becoming obligated on a banker's instrument, the bank may extend credit to the paying party. As well, the paying party may also pay by personal cheque which is subsequently dishonoured. Default by the paying party may be in conjunction with the paying party's insolvency.

paying party's defences against the creditor. Obviously, where the obligated bank successfully avoids making payment to the holder, payment (in fact reimbursement) ought to be made to the paying party.

Assuming good faith and a lack of adverse knowledge on the holder's part, equity considerations unequivocally support the holder's right to enforce payment against the bank over the bank's own defences against the paying party. However, where a breaching (or an allegedly breaching) creditor purports to enforce payment against the bank over the paying party's defences, thereby blocking the paying party's chance to obtain reimbursement from the bank and forcing the paying party to sue the creditor for damages resulting from the breach, policy considerations are not that straightforward. On the one hand, it has been argued that the banker's instrument is perceived as a substitute for cash so that its holder ought not to be exposed but to a claim for damages (in the aftermath of payment).¹⁴ On the other hand, it was argued that cash equivalence does not forfeit tracing or other equitable *in rem* remedies designed to seize funds (as well as the means to get them) held by a fraudulent payee.¹⁵

The Act does not deal directly with the subject. Some American courts have attempted to deal with the autonomy of the banker's instrument by treating it as establishing "a debtor-creditor relationship between the issuing bank and the payee".¹⁶ In this context, it was stated that the banker's instrument "stands on its own foundation as an independent, unconditional and primary obligation of the ... [issuing] [b]ank"¹⁷ and that "[t]o allow the bank to stop payment on such an instrument would be inconsistent with the representation it makes in issuing the ... [instrument]".¹⁸ As one commentator put it, between payee and issuer, "payee has a duty to present the ... [instrument] and the right to receive payment, while ... [issuer] has a duty to pay the ... [instrument] upon presentment".¹⁹

Such views as to the autonomy or the absolute nature of the banker's instrument are heavily influenced by the autonomy of the letter of credit. The opening of the letter of credit by the account party generates a separate and absolute engagement of the issuing bank to pay the beneficiary upon compliance with the terms of the letter of credit, irrespective of the account party's claims and defences against the beneficiary under the contract paid for by the

¹⁴ A leading proponent of this view is L. Lawrence, *Making Cashier's Checks and Other Bank Checks Cost-Effective: A Plea for Revision of Articles 3 and 4 of the Uniform Commercial Code* (1979-80), 64 Minn. L. Rev. 275, at p. 318.

¹⁵ P.M. Shupack, *Cashier's Checks, Certified Checks, and True Cash Equivalence* (1985), 6 Cardozo L. Rev. 467, at pp. 476-478.

¹⁶ *Moon Over the Mountain Ltd. v. Marine Midland Bank*, 386 N.Y.S. 2d 974, at p. 975 (Civ. Ct. N.Y.C. 1976). Of course, such a direct relationship exists where the banker's instrument is given to the payee in discharge of an obligation owed by the bank. See, for example, *Myers v. First National Bank of Scotia*, 345 N.Y.S. 2d 204, at p. 206 (App. Div. 1973).

¹⁷ *Pennsylvania v. Curtiss Nat'l Bank*, 427 F. 2d 395, at p. 400 (5th Cir., 1970).

¹⁸ *National Newmark & Essex Bank v. Giordano*, 268 A. 2d 327, at p. 329 (Law Div. N.J., 1970).

¹⁹ M.L. Cohen, *Comment* (1965-66), 15 Buff. L. Rev. 193, at pp. 195-196.

letter of credit.²⁰ Nonetheless, these views do not constitute a good analysis under the law of negotiable instruments.

As explained below, the creditor's freedom from the banker's defences against the paying party hinges on the question of the payee as a holder in due course. This issue is discussed below in Part I. The availability to the bank of the paying party's defences against the creditor is a question of *jus tertii*, namely of the availability of third person's claims or defences to a party sued on a negotiable instrument who has no claim or defence of his or her own. This issue is discussed below in Part II. In the final analysis, the question of the autonomy of the banker's instrument thus becomes an exercise in the statutory interpretation of the Act which requires the resolution of some fundamental doctrinal issues in the law of negotiable instruments.

The ultimate conclusion of this article is that a holder in due course holds the instrument free from the banker's as well as from the paying party's claims and defences. A payee of a banker's instrument taking it in good faith, for value and without notice, may qualify as a holder in due course. Conversely, a breaching creditor is not a holder in due course. The paying party's claims, including those based on the retroactive cancellation of the obligation for which the instrument was given (but no other contract defences) are available to the bank as against the creditor.

I. The Issuing Bank's Defences Against the Paying Party:

Can the Payee-Creditor Be a Holder in Due Course?

Obviously, the banker's defences against the paying party/debtor cannot be raised against a holder in due course. The latter "holds the ... [instrument] free from any defect of title of prior parties, as well as from mere personal defences available to prior parties among themselves and may enforce payment against all parties liable on the ... [instrument]".²¹ A holder in due course is a holder²² who has taken the instrument "complete and regular on the face of it", who became the holder "before the ... [instrument] was overdue and without notice that it had been ... dishonoured", and who took the instrument in good faith and for value and without notice "at the time the ... [instrument] was negotiated to him" of "any defect in the title of the person who negotiated it".²³

Taking by negotiation is thus one of the prerequisites for becoming a holder in due course.²⁴ "Negotiation" ought to be distinguished from "issue"; while

²⁰ For the autonomy of the letter of credit, see, for example, G.B. Graham and B. Geva, *Standby Credits in Canada* (1984), 9 Can. Bus. L.J. 180, at pp. 190-205.

²¹ Sec. 73(b) (Can.); sec. 38(2) (U.K.). Here and elsewhere "instrument" substitutes "bill", since the provisions governing bills apply to cheques and notes as well. See sec. 165(2) and 186 (Can.) or sec. 73 and 89 (U.K.).

²² For the definition of "holder" see, *infra*, text around footnote 30.

²³ Sec. 55(1) (Can.); sec. 29(1) (U.K.).

²⁴ But see, *St. Martin Supplies Inc. v. Boucley*, [1969] C.S. 324, at p. 325 (Quebec), holding that the subsection does not require taking by negotiation; rather, according to that

"issue" is "the *first delivery* of ... [an instrument], complete in form, to a person who takes it as a holder", "negotiation" is the *transfer* of an instrument from one person to another "in such a manner as to constitute the transferee the holder of the ... [instrument]".²⁵ While an instrument²⁶ payable to bearer is negotiated by delivery, an instrument payable to order is negotiated "by the endorsement of the holder"²⁷ completed by delivery.²⁸

Except for a certified cheque whose certification is procured other than by the paying party (the drawer), a banker's instrument is usually first delivered by the issuing bank to the paying party.²⁹ "Holder" is defined to mean "the payee or endorsee of ... [an instrument] who is in possession of it, or the bearer thereof".³⁰ Thus, for the paying party in possession of a banker's instrument first delivered to him³¹ by the issuing bank to be "holder", the instrument must have been made payable to the bearer. Alternatively, it must have been made payable to the paying party. Otherwise, being neither the bearer nor the payee (as well as the endorsee), the paying party in possession of a banker's instrument made payable to his creditor is not its holder. Thus, as explained below, *prima facie*, the delivery of the banker's instrument by the paying party to his creditor fulfils the statutory requirements for "negotiation" only where the banker's instrument is payable to bearer or where it is payable to the paying party, but not where it is payable to the paying party's creditor.

It was argued that the issue of an instrument payable to bearer, by means of delivery, may also constitute negotiation so that its first bearer³² may qualify as a holder in due course.³³ Regardless, delivery by the first bearer to a second one,

judgment, the subsection merely requires that *if the bill were negotiated*, to be a holder in due course, the new holder must not have received notice of a defect of title at the time of the negotiation.

²⁵ Sec. 2 (Can. as well as U.K.) ("issue"); sec. 59(1) (Can.); sec. 31(1) (U.K.) ("negotiation"). (Emphasis added).

²⁶ Sec. 59(2) (Can.); sec. 31(2) (U.K.).

²⁷ Sec. 59(3) (Can.); sec. 31(3) (U.K.) (where "indorsement" substitutes "endorsement").

²⁸ Sec. 2 (Can. as well as U.K.); sec. 31(3) (U.K.). The modifying conditions in the case of a cheque delivered to a bank for deposit into an account (for example, sec. 165(3) (Can.) or the Cheques Act, 1957 (U.K.), 5 & 6 Eliz. 2, c. 36) are outside the scope of the present inquiry.

²⁹ Where the issuing bank delivers the instrument directly to the creditor of the paying party, it does so on behalf of the paying party. In theory we have then two deliveries: from the issuing bank to the paying party, and from the paying party to the creditor.

³⁰ Sec. 2 (Can. as well as U.K.; the latter uses "indorsee" rather than "endorsee").

³¹ Throughout this article, "him", includes "her" or "it"; "he" includes "she" or "it"; and "his" includes "hers" or "its". Otherwise, I aim at being gender neutral.

³² "Bearer" is defined in sec. 2 (Can. as well as U.K.) as "the person in possession of a bill or note ... payable to bearer".

³³ Cf. F.R. Malan, Bills of Exchange, Cheques and Promissory Notes in South African Law (1983), para. 114, arguing that "if a bill payable to bearer is delivered by the drawer to the payee, the delivery will be not only an issue but also a negotiation". In this quoted language, the use of the word "payee" in connection with a bearer instrument is unfortunate. In any event, contrary to the statement in the accompanying text, it is more plausible to

is negotiation.³⁴ This is so even where the second bearer is the payee of an instrument payable to payee or bearer, as such an instrument is treated as payable to bearer.³⁵ Thus, the payee of a banker's instrument payable to payee or bearer, to whom the instrument has been delivered by the paying party (the latter being its first bearer/holder) may qualify as a holder in due course.³⁶

Also, an endorsee in possession of an instrument payable to order is a taker by negotiation. Accordingly, in connection with a banker's instrument made payable to the paying party's creditor, an endorsee in possession of the instrument may qualify as a holder in due course.³⁷ Furthermore, where the banker's instrument was made to the order of the paying party/debtor, and endorsed by him to his creditor, this creditor himself is a taker by negotiation, capable of qualifying as a holder in due course.

However, a payee of an instrument payable to order is not a taker by endorsement from the holder. Being the first holder of the instrument, the payee takes the instrument neither by endorsement nor from a previous holder. Rather the payee appears³⁸ to be the person to whom the instrument is "issued" rather than "negotiated".³⁹ The conventional interpretation of the Act is thus that a payee may not be a holder in due course.⁴⁰

So far, the inevitable conclusion appears to be that the banker's defences against the paying party/debtor may be asserted against the creditor payee of the banker's instrument. Not being a holder in due course, the payee/creditor does not hold the instrument "free from any defect of title of prior parties, as well as from mere personal defences available to prior parties among themselves".⁴¹

argue that inasmuch as the "issue" of a bearer instrument does not involve a transfer conferring a derivative title on a transferee, no "negotiation" is thereby carried out.

³⁴ See, for example, *Golden Prism v. But-Shor Investments & Distributors (Pty.) Ltd.*, [1978] 1 S.A. 512, at p. 515 AB (Durban and Coast Local Div.), for the negotiation from an agent (the first bearer) to a principal (the second bearer) so as to make the latter a holder in due course.

³⁵ See, for example, *Johnson v. Johnson*, [1928] 2 D.L.R. 912 (Alta. A.D.).

³⁶ See, for example, *Commonwealth Trading Bank of Australia v. Sydney Raper Pty. Ltd.* (1975), 25 F.L.R. 217, at p. 245 (N.S.W.S.C.).

³⁷ The collecting bank in which the banker's instrument is deposited may be covered.

³⁸ However, this appearance could be misleading. See the ensuing discussion in this section.

³⁹ For this distinction, see *supra*, text and footnotes 24-28.

⁴⁰ See, for example, F.R. Ryder and A. Bueono, *Byles on Bills of Exchange* (26th ed., 1988), pp. 38, 218; A.G. Guest, Chalmers and Guest on Bills of Exchange, Cheques and Promissory Notes (14th ed., 1991), p. 275; D.V. Cowen and L. Gehring, *Cowen on the Law of Negotiable Instruments in South Africa* (4th ed., 1966), pp. 275-278; Malan, *op. cit.*, footnote 33, para. 179; B. Conrick, MJL Rajanayagam's *The Law of Negotiable Instruments in Australia* (2d ed., 1989), para. 9.8; B. Crawford, *Crawford and Falconbridge Banking and Bills of Exchange* (8th ed., 1986), Vol. 2, pp. 1474-1478, who is quite critical of this interpretation. For a previous critical view by this author, see B. Geva, *Reflections on the Need to Revise the Bills of Exchange Act (1981-82)*, 6 Can. Bus. L.J. 260, at pp. 289-301. The most comprehensive and thorough critique is R.W. Aigler, *Payees as Holders in Due Course (1926-27)*, 36 Yale L.J. 608.

⁴¹ See text *supra*, at footnote 21.

Indeed, in Australia, *Commonwealth Trading Bank of Australia v. Sydney Raper Pty. Ltd.*⁴² did not allow the payee of a banker's instrument to enforce it against the issuing bank over the latter's defences against the paying party.⁴³ However, in that case, the instrument, though made payable to the payee or bearer,⁴⁴ was crossed "not negotiable", so as to allow transferability only subject to defects in the transferor's title.⁴⁵ Furthermore, payee did not comply with the taking for value requirement.⁴⁶ As such, payee could not become a holder in due course.⁴⁷

Nonetheless, the decision alarmed the financial community. It was feared that its implications might undermine the cash quality of the banker's instrument.⁴⁸ Ultimately, in response to the Law Society's request for "a definitive statement from banks regarding the circumstances under which ... [banker's instruments] will be dishonoured", the Australian Bankers' Association advised that:

Where there has been failure of consideration for the issue of a ... [banker's instrument], the issuing bank may dishonour the ... [instrument] only if either:

- the holder has not given value for the ... [banker's instrument],⁴⁹ or
- if the holder has given value, the holder had, at the time of giving value, knowledge of the failure of consideration for the issue of the ... [banker's instrument].⁵⁰

⁴² *Supra*, footnote 36. See also *Justin Seward Pty. Ltd. v. Commissioners of Rural and Industries Bank* (1980), 60 F.L.R. 51 (W.A. Dist. Ct.).

⁴³ In *Sydney Raper*, *ibid.*, the Australian issuing bank delivered the banker's instrument to the paying party in consideration for an American banker's instrument which was subsequently dishonoured by the American issuing bank. There was thus failure (and not absence as may be implied from the judgment) of consideration for the Australian banker's instrument from the paying party to the Australian issuing bank. Whether the American bank was justified in dishonouring its banker's instrument is outside the scope of the present inquiry. We are concerned with the enforceability of the Australian banker's instrument, against the Australian issuing bank, where the consideration from the paying party to the Australian issuing bank failed (due to the dishonour of the American banker's instrument).

⁴⁴ For the significance of this practice, see text, *supra*, around footnotes 32-36.

⁴⁵ Under the corresponding section to sec. 174 (Can.) and sec. 81 (U.K.). Neither "not negotiable" (or any other) crossing nor the practice of payment instruments issued to payee or bearer is prevalent in Canada.

⁴⁶ For this requirement, see text, *supra*, around footnotes 22-23.

⁴⁷ See primarily *supra*, footnote 36, at pp. 240-242 (judgment of Glass J.A.).

⁴⁸ The fears were not universally shared. See, for example, W.S. Weerasooria, *The Australian Bank Cheque - Some Legal Aspects* (1975-76), 2 Monash U.L. Rev. 180, at pp. 187-189; R. Makim, *The Australian Bank Cheques - Some Further Legal Aspects* (1976-77), 3 Monash U.L. Rev. 66, at p. 68. Both emphasized, albeit without any doctrinal reasoning, that *Commonwealth Trading Bank of Australia v. Sydney Raper Pty. Ltd.*, *supra*, footnote 36, does not affect the position of a holder who took the banker's instrument in good faith and for value.

⁴⁹ In the context of holder in due course requirements, "value" means executed consideration of *quid pro quo*; executory consideration, such as a promise, will not suffice. See, for example, Cowen and Gehring, *op. cit.*, footnote 40, pp. 283-285.

⁵⁰ See N. Mainwaring, *Dishonouring Bank Cheques* (1985), 25 L. Soc. J. 430. Other ground for dishonour were stated to be forgery or counterfeiting, material alteration, or advice of theft or loss. These grounds are outside the scope of the present inquiry.

Stated otherwise, a payee taking the instrument in good faith and for value is protected.

Being consistent with the cash quality of the banker's instrument, this solution is quite attractive. However, this is a pragmatic solution with no doctrinal underpinning. Rather than being based on law, it is based on the goodwill of the banking community.

In the United States, under Article 3 of the Uniform Commercial Code, a payee may be a holder in due course. The predecessor of Article 3, the Uniform Negotiable Instruments Law ("N.I.L.") contained statutory language similar to that of the Act. It thus required the holder in due course to take by negotiation,⁵¹ and defined "negotiation" of an instrument payable to order in terms of the endorsement by a previous holder.⁵² Original Article 3 abandoned this language by setting out that a holder in due course must *take* the instrument for value, in good faith and without notice of adverse facts,⁵³ but need not necessarily *take it by negotiation*. Furthermore, original paragraph 3-302(2) explicitly stated that "[a] payee may be a holder in due course". Specific examples given by the Comment included that of payment by banker's instrument.⁵⁴

Revised Article 3 follows its predecessor in not requiring the holder in due course to take by negotiation.⁵⁵ Original paragraph 3-302(2), specifying that a payee may be a holder in due course, has been omitted as superfluous.⁵⁶ The Official Comment specifically refers to the banker's instrument scenario as a typical setting where a payee may be a holder in due course.⁵⁷ In any event, under revised Article 3, the delivery of a banker's instrument payable to the creditor, by the paying party to the creditor, is treated as "negotiation".⁵⁸

⁵¹ N.I.L., sec. 52(4). For the corresponding provision under the Act, see text, *supra*, around footnote 3.

⁵² *Ibid.*, sec. 30. For the corresponding provision under the Act, see the text, *supra*, around footnotes 6-8.

⁵³ Pre 1990 UCC, § 3-302(1).

⁵⁴ Comment 2, illustrations (a) and (b) (pre 1990 UCC § 3-302).

⁵⁵ Rev. (1990), UCC § 3-302(2).

⁵⁶ See Official Comment 4 to Rev. (1990), UCC § 3-302. In the view of the drafters such a provision may also be misleading since "use of the holder-in-due-course doctrine by the payee ... is not the normal situation".

⁵⁷ See Case #1 in Official Comment 4 to Rev. (1990), UCC § 3-302, combining the two illustrations referred to, *supra*, footnote 54.

⁵⁸ See Rev. (1990), UCC § 3-201 whose predecessor, pre 1990 UCC § 3-202(1), was somewhat ambiguous; thereunder, negotiation of an instrument payable to order was stated to be "by delivery with any necessary indorsement". (Emphasis added). Under Rev. (1990), UCC § 3-201(a), the negotiation of a banker's instrument by the paying party to the payee is *sui generis*. Under Rev. (1990), UCC § 3-105(a) (as it was under its predecessor pre 1990 UCC § 3-102(1)(a)), the delivery of the banker's instrument payable to the paying party's creditor by the issuing bank to the paying party qualifies as the "issue" of the instrument. For the "negotiation" and "issue" under the Act, see the text, *supra*, around footnotes 24-28. For the application of these concepts to the banker's instrument under the Act, see the text, *supra*, the text around footnotes 29-40.

It should be pointed out that to defeat a claim or defence, the holder in due course must be a remote, not immediate, party *vis-à-vis* the one raising that claim or defence.⁵⁹ Thus, *vis-à-vis* a prior party, only a remote party could become a holder in due course. Two parties in privity with each other are immediate parties. Otherwise, they are remote parties.⁶⁰ A payee is usually an immediate party *vis-à-vis* the maker or drawer; an endorsee is a remote party in relation to the maker or drawer. By conferring a derivative title to the instrument on the transferee, negotiation is thus a machinery generating the required remoteness between the party preceding the transferor and the transferee (for example, between the drawer or maker and the first endorsee). However, in a bill of exchange, the payee is a remote party *vis-à-vis* the acceptor, though the bill has not been negotiated to him. Such "remoteness" is adequate to make the payee a holder in due course *vis-à-vis* the acceptor under the UCC; *prima facie*, it appears to fall short of satisfying the taking by negotiation requirement (and hence, the holding in due course standard) under the Anglo-Canadian Act.⁶¹

Nevertheless, it can be argued that notwithstanding what appears to be clear statutory language to the contrary,⁶² the payee of a banker's instrument may be treated under the Anglo-Canadian Act as one who has taken the instrument by negotiation. Underlying this interpretation of the Act is the proposition that unlike a usual payee, the payee of a banker's instrument is a remote party *vis-à-vis* the issuer. Such a payee has a derivative title to the instrument conferred upon him by the paying party. Indeed, the rights to and on the instrument of the remitter, namely someone who procures or purchases⁶³ from an issuer an instrument payable to another⁶⁴ who has not transferred the instrument yet, go back to the law merchant and early English law.⁶⁵ Not being a holder, the

⁵⁹ The holder in due course is insulated only from claims and defences of prior parties. See provision *supra*, footnote 21.

⁶⁰ Persons are "immediate parties" where they are in direct relation with each other; that is, "if their legal relations as parties to an instrument arise out of their direct dealings with each other". All other parties are "remote". See Crawford, *op. cit.*, footnote 40, p. 1519 and Guest, *op. cit.*, footnote 40, p. 225.

⁶¹ For a historical and doctrinal perspective on the payee's position *vis-à-vis* the acceptor, see *infra*, footnotes 149-154.

⁶² See text *supra*, around footnotes 24-28 and further amplified text, *supra*, around footnotes 29-40.

⁶³ Inasmuch as the remitter has an original and not derivative title to the instrument (see text, *infra*, at footnote 65), the use of the word "purchase", though quite common, may be misleading in this context.

⁶⁴ For this term, see, for example, *Munroe v. Bordier* (1849), 8 C.B. 862, at pp. 871-872, 137 E.R. 747, at p. 751 (C.P.). "Remitter" is currently defined in Rev. (1990), UCC § 3-103(11) as "a person who purchases an instrument from its issuer if the instrument is payable to an identified person other than the purchaser". There is no corresponding provision in the Act.

⁶⁵ For a comprehensive and thorough study, see F.K. Beutel, *Rights of Remitters and Other Owners not within the Tenor of Negotiable Instruments* (1927-28), 12 Minn. L. Rev. 584.

remitter is best viewed as the first owner of the instrument.⁶⁶ The paying party procuring a banker's instrument payable to his creditor is such a remitter, having power to recover on the instrument as well as to transfer it, particularly⁶⁷ to the payee (the paying party's creditor). It is in this sense that the payee of a banker's instrument procured by a remitter is a remote party *vis-à-vis* its issuer, with a derivative title to the instrument, conferred to him by the paying party/remitter.

Indeed, the delivery of a banker's instrument from the paying party to the creditor is not "the first delivery" of the instrument so as to constitute its issue.⁶⁸ Rather, it is the transfer of an existing instrument from one person to another "in such a manner as to constitute the transferee the holder of the ... [instrument]" so as to fall into the broad definition of "negotiation".⁶⁹ True, there are two subsections providing what constitutes "negotiation". The first deals with the negotiation of an instrument payable to bearer. The second deals with the negotiation of an instrument payable to order, requiring it to be "by the endorsement of the *holder*"⁷⁰ rather than that of the remitter. These subsections should, however, be taken as providing examples for the most common situations of "negotiation" rather than circumventing or restricting the broad definition of "negotiation". That is, the two subsections should not be taken to exhaust all cases of "negotiation". Accordingly, there is room for more instances of "negotiation" not provided for by the two subsections, which are nonetheless within the broad concept of "negotiation" as a transfer (rather than an issue) to a holder.⁷¹

A few pre-Act cases in England regarded the payee who took a bill of exchange in good faith and for value from a remitter⁷² as a *bona fide* holder for

⁶⁶ See, for example, W.E. Britton, *Handbook of the Law of Bills and Notes* (2nd ed., 1961), p. 179, where the author goes on to explain that the remitter may wish to exercise ownership rights where the payee rejects the instrument, or where the remitter (in possession of the instrument) chooses to transfer it to someone other than the payee.

⁶⁷ But not exclusively. The remitter may effectively transfer the instrument to someone other than the payee, and will use this power upon changing his mind, or the rejection of the instrument by the payee, *ibid*. The substitute payee is unlikely to take the instrument "regular on the face of it" (see, *supra*, the text around footnote 23), and thus disqualifies as a holder in due course.

⁶⁸ See text, *supra*, around footnote 24. Note, however, that technically speaking, unlike under the UCC (see, *supra*, footnote 58), under the statutory language of the Act, a banker's instrument is never "issued", since the "first delivery" of the instrument (from the issuer to the remitter) is not to a holder. Practically speaking, this "first delivery" from the issuer to the remitter is the equivalent of "issue".

⁶⁹ See text, *supra*, around footnote 25.

⁷⁰ See text, *supra*, around footnotes 26-28. (Emphasis added).

⁷¹ For a discussion, see Note, R. Windham (1927), 3 Camb. L.J. 84. See also, F.K. Beutel, *Beutel's Brannan Negotiable Instruments Law* (7th ed., 1948), pp. 675-676, with a subsequent case law discussion (from an American pre UCC perspective); note that the N.I.L. statutory scheme was substantially identical to that currently under the Anglo-Canadian Act. See text, *supra*, around footnotes 51-52.

⁷² But not from the payee's agent. See, for example, *De Bras v. Forbes* (1792), 1 Esp. 116, 170 E.R. 298 (C.P.), specifically distinguished on that ground in *Munroe v. Bordier*, *supra*, footnote 64, at pp. 870 (C.B.), 750-751 (E.R.).

value⁷³ who may recover from the drawer/issuer notwithstanding the failure of consideration given by the remitter to the drawer/issuer.⁷⁴ The leading case is *Munroe v. Bordier*.⁷⁵ Wilde C.J. observed that the ordinary course of dealing with a bill procured or purchased⁷⁶ by a remitter⁷⁷ “begins by the sale of the bill by the drawer to some person other than the payee” so that that person, namely the remitter,⁷⁸ “should have a right to confer a title to the bill upon the payee”.⁷⁹ Having thus established the payee’s derivative title, Wilde C.J. went on to decide on the facts of the case that the remitters actually delivered the bill to the payees “who received it bona fide, and for value”.⁸⁰ He thus concluded “that the [payees] acquired a good title to the bill, and may sue the drawers upon it, although ... [the drawers] have never received value for it ... [from the remitters]”.⁸¹ Also in *Poirier v. Morris*,⁸² under similar circumstances, payees were regarded as “bona fide holders for value”.⁸³ Finally, in *Watson v. Russell*,⁸⁴ the payee, who took a cheque from a remitter⁸⁵ for “value without notice”⁸⁶ was entitled to prevail over the drawer.

The argument that under pre-Act case law the payee could be a holder in due course is bolstered by the Indian Negotiable Instruments Act.⁸⁷ The statute,

⁷³ For the equivalency between this term and “holder in due course” (notwithstanding *Malan, op. cit.*, footnote 33, para. 179), see text, *infra*, around footnotes 101 and 109.

⁷⁴ For this interpretation of these cases, see particularly Aigler, *loc. cit.*, footnote 40, at pp. 609-611; Crawford, *op. cit.*, footnote 40, p. 1477 (and see text, *supra*, around footnote 30); *Malan, ibid.*

⁷⁵ *Supra*, footnote 64.

⁷⁶ See, *supra*, footnote 63.

⁷⁷ On the facts of the case, the remitter was required to place funds with the issuer a day after the issue of the instrument and its subsequent delivery to the payee. However, the remitter failed prior to making payment to the issuer. This transaction reflected the contemporary mercantile practice in London for foreign bills of exchange.

⁷⁸ More specifically, the judgment did not identify the remitter as the person “to confer a title ... upon the payee”; rather, the court said the transaction was not such “that no person but the drawer should have a right to confer title to the bill upon the payee”. Practically speaking, this singles out the remitter as the person to confer such a title.

⁷⁹ *Munroe v. Bordier, supra*, footnote 64, at pp. 872 (C.B.), 751 (E.R.). In making this statement, Wilde C.J. explicitly relied on classical authorities, that is, Beawes’s *Lex Mercatoria*, Bills of Exchange, para. 6, p. 416, citing Marius, p. 22.

⁸⁰ *Ibid.*, at pp. 873 (C.B.), 752 (E.R.).

⁸¹ *Ibid.* As indicated *supra*, footnote 77, the remitter failed prior to providing the consideration to the issuing drawers.

⁸² (1853), 2 EL. & BL. 89, 118 E.R. 702 (Q.B.).

⁸³ *Ibid.*, at pp. 104, 107 (EL. & BL.), 708, 709 (E.R.).

⁸⁴ (1864), 5 B. & S. 968, 122 E.R. 1090 (Ex. Ch.), aff’d (1862), 3 B. & S. 34, 122 E.R. 14 (Q.B.).

⁸⁵ Nonetheless, in that case, the drawer was a subcharterer of the ship from the remitter (the charterer) and the cheque was in payment of the remitter-charterer’s hire to the owner’s shipbroker. This facilitated a narrower interpretation of this case. See text, *infra*, around footnotes 117-119.

⁸⁶ *Supra*, footnote 84, at pp. 969 (B. & S.), 1091 (E.R.) (Ex. Ch.).

⁸⁷ Act XXVI of 1881 (as am. up to March 1989). For Indian law update, I am grateful to Professors Menon and Rao of the National Law School of India University.

passed in 1881, one year before the Imperial Bills of Exchange Act, was stated to be "based upon the English common law relating to promissory notes, bills of exchange and cheques" so as to constitute "mainly a codification of the English common law on the subject".⁸⁸ Under section 9 of the Indian Act, a holder in due course must have taken the instrument for consideration, before it became overdue and without notice of any defect "in the title of the person from whom he derived his title". With respect to an instrument payable to order, the holder in due course could be "the payee or indorsee thereof", provided the foregoing conditions have been met. As under the English and Canadian statutes,⁸⁹ "negotiation" under the Indian Act is a transfer to a holder⁹⁰ and an instrument payable to order "is negotiable by the holder by endorsement and delivery";⁹¹ nonetheless, under the Indian Act, while a holder in due course must have a derivative title, such a title, strictly speaking, need not be acquired by "negotiation".⁹²

Unfortunately, the eligibility of the payee to be a holder in due course is not dealt with directly by Chalmers' pre-Act edition of his treatise.⁹³ Attempting "to state methodically the law as it is",⁹⁴ Chalmers nevertheless appears to overlook the specific point. Indeed, he recognized, on the basis of *Watson v. Russell*,⁹⁵ that there are circumstances where the maker and the payee of a note are remote parties.⁹⁶ He further acknowledged on the basis of *Munroe v. Bordier*⁹⁷ as well as *Watson v. Russell* that a payee taking the instrument from a remitter⁹⁸ is a holder for value so that "[i]t is immaterial that there is no consideration between ... [the issuer] and ... [the remitter], or that the consideration fails".⁹⁹ Nonetheless, he did not expand on the defence-free position of the remote payee; nor did he articulate its underlying theory.¹⁰⁰ At the same time,

⁸⁸ M.S. Parthasarathy, J.S. Khargamvala on the Negotiable Instruments Act (17th ed., 1990), p. 1.

⁸⁹ See text, *supra*, around footnotes 24-28.

⁹⁰ Sec. 14.

⁹¹ Sec. 46.

⁹² See, *supra*, text that follows footnote 88.

⁹³ M.D. Chalmers, A Digest of the Law of Bills of Exchange, Promissory Notes and Cheques (1878). The treatise is currently in its 14th edition (Guest, *op. cit.*, footnote 40).

⁹⁴ *Ibid.*, p. vi.

⁹⁵ See, *supra*, text around footnotes 84-86.

⁹⁶ Chalmers, *op. cit.*, footnote 93, p. 74 (illustration 2). This illustration was also included in p. 101 of the 13th edition (D.A.L. Smout, ed. (1964)), before the text was completely rewritten as the 14th edition by Guest, *c.f.* Guest *op. cit.*, note 40, p. 227.

⁹⁷ *Supra*, footnote 64 (see also, *supra*, text around footnotes 72-81).

⁹⁸ It is implicit that taking was for value and in good faith.

⁹⁹ Chalmers, *op. cit.*, footnote 93, p. 69 (illustration 3). This illustration was also included at p. 89 of the 13th edition. As for the 14th edition *c.f.* Guest, *op. cit.*, footnote 40, p. 339.

¹⁰⁰ In this author's view, these omissions led to an unnecessary confusion obscuring doctrine relating to the holder for value, consideration and absence of consideration in the law of bills and notes, as expressed, for example, in *Diamond v. Graham*, [1968] 1 W.L.R. 1061 (C.A.). For the view that the latter was actually a payee as a holder in due course case, see B. Geva, Absence of Consideration in the Law of Bills and Notes (1980), 39 Camb. L.J.

Chalmers' definition of the "bona fide holder for value without notice", the forerunner of the holder in due course,¹⁰¹ is that of "a holder for value who, at the time he becomes the holder and gives value, is really and truly without notice of any facts which, if known, would defeat his title to the [instrument]".¹⁰² This definition does not require taking by negotiation; it is thus broad enough to cover the payee. In fact, the "bona fide holder for value without notice" is not required even to have a derivative title!¹⁰³

There is no indication that the drafters of the Imperial Bills of Exchange Act specifically purported to overrule earlier case law allowing the payee to be a holder in due course. However, in the landmark case of *Bank of England v. Vagliano Bros.*,¹⁰⁴ Lord Herschell was of the opinion that pre-Act case law was irrelevant in the interpretation of the provision of a codifying statute such as the Imperial Bills of Exchange Act.¹⁰⁵ Rather:¹⁰⁶

The proper course is in the first instance to examine the language of the statute and to ask what is its natural meaning, uninfluenced by any considerations derived from the previous state of the law, and not to start with inquiring how the law previously stood, and then, assuming that it was probably intended to leave it unaltered, to see if the words of the enactment will bear an interpretation in conformity with this view.

Against the specific statutory language requiring the holder in due course to take by negotiation, and the definition of negotiation of instrument payable to order as the endorsement of the holder completed by delivery, it seems hard to argue that pre-Act cases permitting the payee to qualify as a holder in due course survived the passage of the Act.

Nonetheless, in the final analysis, this objection based on *Vogliano* is not valid. Thus, the proposed interpretation of the Act as encompassing "negotiation" by the nonholder-remitter to the payee¹⁰⁷ is not based on the technical argument as to the admissibility of pre-Act cases. Rather, it is driven by the desire to read the Act as accommodating the payee who has taken the instrument from a remitter. That is, underlying the proposed interpretation are policy objectives and not a restrictive outlook purporting to interpret a codifying statute as much as possible in line with prior case law. Lord Herschell's objection to the admissibility of pre-Act cases must be taken to apply only to

360, at pp. 368-369, as well as B. Geva, *Financing Consumer Sales and Product Defences in Canada and the United States* (1984), pp. 150-151.

¹⁰¹ For the interchangeability of these two terms see, for example, M.D. Chalmers, *A Digest of the Law of Bills of Exchange, Promissory Notes and Cheques* (3d ed., 1887), pp. 102-103. See also, *infra*, text around footnote 109.

¹⁰² Chalmers, *op. cit.*, footnote 93, p. 71.

¹⁰³ *Cf., infra*, text around footnotes 149-153.

¹⁰⁴ [1891] A.C. 107 (H.L.).

¹⁰⁵ But according to Fletcher Moulton L.J. in *Lloyd's Bank Ltd. v. Cooke*, [1907] 1 K.B. 794, at p. 807 (C.A.), "there is a strong presumption against any serious change in the general law being intended" by a codifying statute.

¹⁰⁶ *Supra*, footnote 104, at pp. 144-145.

¹⁰⁷ See, *supra*, the text around footnotes 68-71.

such a restrictive use of prior case law. In our situation, pre-Act cases reinforce an interpretation which would have been put forward irrespective of them.

Confirmation of the proposed statutory interpretation and the continued force of pre-Act cases upholding the payee's eligibility to become a holder in due course comes from observations made by Fletcher Moulton L.J. in *Lloyd's Bank Ltd. v. Cooke*.¹⁰⁸ First, he was satisfied that "the term 'holder in due course', which is used in the Act, is intended to be the equivalent of the term 'bona fide holder for value' which was used prior to the Act, and which would ... have included a payee who had given full value for the bill or note in good faith".¹⁰⁹ He could not see any indication that the Act was designed to introduce any change regarding this point.

Second, in connection with an instrument payable to order, he declined to construe the word "negotiated" as being merely equivalent to "indorsed". Rather, on the basis of the general statutory definition of "negotiation" as a transfer to a holder,¹¹⁰ "it appears clear that the Legislature intended to make it apply also to the original operation of transferring the bill to the payee"; this is so since the definition "carefully abstains from prescribing that the transferor must be a 'holder'".¹¹¹ His ultimate conclusion was "that the Act did not intend to impair the position of the payee as contrasted with that of an indorsee, and that a payee who has given value in good faith is intended to come within its provisions as a 'holder in due course' just as much as an indorsee".¹¹²

*R.E. Jones Ltd. v. Waring and Gillow, Ltd.*¹¹³ is the leading authority for the proposition that under the Act a payee may not be a holder in due course.¹¹⁴ In their judgments, several law lords explicitly disapproved of Fletcher Moulton L.J.'s views in *Lloyd's Bank Ltd. v. Cooke*.¹¹⁵ However, in *Jones v. Waring*, the House of Lords refrained from explicitly reversing the pre-Act remitter cases.¹¹⁶ In fact, only *Watson v. Russell*¹¹⁷ was discussed. In distinguishing it, the law lords regarded the intermediary who had taken the cheque from the drawer and delivered it to the payee, not as a remitter but, rather, as the drawer's agent.¹¹⁸ According to this interpretation, having failed to communicate to the payee a

¹⁰⁸ *Supra*, footnote 105. This was a case of unauthorized completion of a blank instrument by an intermediary (and not a remitter case). The other judges held for the payee on the basis of estoppel rather than the holder in due course doctrine.

¹⁰⁹ *Ibid.*, at p. 806.

¹¹⁰ See, *supra*, the text around footnotes 25-28, 68-71.

¹¹¹ *Supra*, footnote 105, at p. 808.

¹¹² *Ibid.*

¹¹³ [1926] A.C. 670 (H.L.).

¹¹⁴ See sources set out, *supra*, in footnote 40.

¹¹⁵ *Supra*, footnote 113, at pp. 680 (Viscount Cave), 687 (Lord Shaw), and 699 (Lord Carson).

¹¹⁶ See, *supra*, the text around footnotes 72-86.

¹¹⁷ See, *supra*, the text around footnotes 84-86.

¹¹⁸ *Supra*, footnote 85. With respect, this interpretation seems to be inconsistent at least with the understanding of the case by the Exchequer Chamber, which was the highest court dealing with the matter. It further overlooks Crompton J.'s broad statement in trial (*supra*,

condition subsequent to payment, stipulated by the drawer and communicated by him to the intermediary but not the payee, the intermediary bound his principal (the drawer) unconditionally to the payee.¹¹⁹ *Monroe v. Bordier*¹²⁰ was not even mentioned by the law lords.

There is pre *Jones v. Waring* Canadian authority upholding the holder in due course position of a payee taker from a remitter.¹²¹ It should not necessarily be assumed that such authority was overruled by *Jones v. Waring*. In effect, since *Jones v. Waring*, the position of the payee taker from a remitter has not formed the ratio of any leading authority. Furthermore, since the passage of the Act, pre-Act remitter cases have not been specifically reversed.¹²² Nor has the proposed interpretation of the Act, as accommodating the holder in due course status of the payee taker from a remitter,¹²³ been explicitly rejected.¹²⁴

Three leading cases denying the payee's holder in due course status under the Act will now be examined in the order in which they were decided. In *Lewis v. Clay*,¹²⁵ a co-maker of a promissory note defended the payee's action pleading fraud perpetrated by the other co-maker. Payee and defendant co-makers were in direct privity. As such they were immediate parties so that payee could not become a holder in due course.¹²⁶ In *Herdman v. Wheeler*,¹²⁷ an intermediary was instructed by the maker to procure a loan in a specific amount from the payee to the maker. The intermediary inserted a higher sum on the pre-signed blank promissory note he had received from the maker, and delivered the completed instrument to the payee. Having received the money from the payee,

footnote 84, at pp. 38 (B. & S.), 16 (E.R.)), not referring to the intermediary as the drawer's agent:

"If A., by means of a false pretence ... procures B. to give him a note or cheque or acceptance in favour of C., to whom he pays it, and who receives bona fide for value, B. remains liable ..."

Cf. Crawford, *op. cit.*, footnote 40, p. 1477 (and see also, *supra*, text around footnote 30).

¹¹⁹ See, for example, *supra*, footnote 105, at pp. 682 (Viscount Cave), 687 (Lord Shaw), and 693-695 (Lord Sumner).

¹²⁰ See, *supra*, the text around footnotes 72-81.

¹²¹ *Gunn's Ltd. v. Wark* (1923), 51 N.B.R. 292, at pp. 300-301 (C.A.), where *Watson v. Russell*, as understood by Chalmers (see *supra*, the text around footnote 96) was followed. In this case, a buyer from a retailer paid for the goods, at the retailer's request, by means of a promissory note payable to the manufacturer (the retailer's creditor). The payee-manufacturer was held to be a holder in due course, holding the note free from the buyer's defences against the retailer. Other pre *Jones v. Waring* Canadian authorities holding that the payee can be a holder in due course are compiled in F. Read (ed.), *MacLaren's Bills, Notes and Cheques* (6th ed., 1940), p. 196.

¹²² But *cf.*, *supra*, the text around footnotes 117-120.

¹²³ See, *supra*, the text around footnotes 68-71.

¹²⁴ But *cf.*, *supra*, the text around footnote 115.

¹²⁵ (1897), 77 L.T. 653 (Q.B.D.).

¹²⁶ In effect, defendant co-maker successfully pleaded *non est factum*. However, the holder in due course issue was also considered by the court as an alternative ground.

¹²⁷ [1902] 1 K.B. 361 (K.B.).

the intermediary pocketed the excess proceeds. Allowing the maker to raise the defence of unauthorized completion of the note by the intermediary, the court in effect found that payee dealt directly with the maker and thus there was privity of contract between them.¹²⁸ In *Jones v. Waring*,¹²⁹ the payee took a cheque from an intermediary who had fraudulently procured it from the drawer by inducing him to make it payable to the payee for a consideration alleged by the fraudulent intermediary to be given to the drawer by the payee. In fact the intermediary used the cheque to pay his own personal debt to the payee. On his part, the drawer thought he was dealing directly with the payee.¹³⁰

In all three cases, the payee did not have a derivative title to the instrument and thus could not become a holder in due course. Unfortunately, the rhetoric of some of the judgments went beyond the particular facts of respective cases. Thus, in *Lewis v. Clay*, Lord Russell C.J. treated the holder in due course and the named payee as two mutually exclusive categories. He observed that "the plaintiff ... [was] named as payee ... and, *therefore*, ... [was] one of the immediate parties", so that the note "[had], in fact, never been negotiated".¹³¹ This appears to suggest the existence of an irrebuttable presumption under which the payee is *always* an immediate party incapable of becoming a holder in due course. In *Herdman v. Wheeler*, Channell J. was "not prepared to hold that a payee ... can never be a holder in due course";¹³² whether "the payee ... may be a holder in due course ... depends upon the actual state of facts as between him and the maker".¹³³ Nonetheless, he specifically stated that "negotiated" meant "transferred by one *holder* to another".¹³⁴ Finally, in *Jones v. Waring*, Viscount Cave expressed the view that the term "holder in due course" does not include the original payee.¹³⁵ He, Lord Shaw and Lord Carson¹³⁶ specifically preferred Lord Russell's view in *Lewis v. Clay*¹³⁷ over that of Fletcher Moulton L.J. in *Lloyd's Bank v. Cooke*.¹³⁸

Falconbridge was of the opinion that *Jones v. Waring* "appears to be open to criticism, as being based on technical and not wholly convincing reasoning,

¹²⁸ *Ibid.*, at p. 374.

¹²⁹ *Supra*, footnote 113.

¹³⁰ A point stressed by Aigler, *loc. cit.*, footnote 40, at p. 619. Nonetheless, payee intended to deal with the remitter. It is thus not entirely clear whether the decision (though distinguishable in part) is totally consistent with the pre-Act remitter cases (discussed, *supra*, footnotes 72-86). Cf. Crawford, *op. cit.*, footnote 40, p. 1477.

¹³¹ *Supra*, footnote 125, at p. 656. (Emphasis added).

¹³² *Supra*, footnote 127, at p. 372.

¹³³ *Ibid.*, at p. 374.

¹³⁴ *Ibid.*, at p. 376. (Emphasis added). Technically, the decision was limited to the proviso of sec. 20 (U.K.), corresponding to sec. 31(1) (Can.), dealing with the holder's in due course power to overcome the defence of unauthorized completion. However, the observations as to what constitutes "negotiation" apply across the board.

¹³⁵ *Supra*, footnote 113, at p. 680.

¹³⁶ *Ibid.*, at pp. 680, 697 and 699 respectively.

¹³⁷ See, *supra*, the text around footnote 131.

¹³⁸ See, *supra*, the text around footnotes 108-112.

and as reaching a conclusion which is not entirely satisfactory from the practical point of view, because there are situations in which the payee should logically be as fully protected as a subsequent holder".¹³⁹ In any event, all three cases would be regarded as limited to their own facts and not affecting the position of a payee taker from a remitter. Indeed, disapproval of *Lloyd's Bank v. Cooke* in *Jones v. Waring* was made in passing, and without thorough analysis. Moreover, *Lloyd's Bank v. Cooke* was not a remitter case,¹⁴⁰ and Fletcher Moulton L.J. used language that might be too broad in implying that a payee taking from the drawer may also qualify as a holder in due course.¹⁴¹ Accordingly, notwithstanding *Jones v. Waring*, a payee taker from a remitter should be regarded as eligible to become a holder in due course. The alternative of explaining the pre-Act remitter cases as establishing the payee's defence-free position on the basis of the payee's status, not as a holder in due course but as a mere *bona fide* holder for value,¹⁴² is quite untenable.¹⁴³ It is historically erroneous¹⁴⁴ and doctrinally unfounded.¹⁴⁵

Nonetheless, the drawer of a cheque whose certification is subsequently procured by the holder is not a remitter.¹⁴⁶ The payee of such a cheque, though a remote party to the transaction between the certifying drawee and the drawer, is not a taker from the remitter. Could such a payee qualify as a holder in due course so as to hold the cheque free from defences available to the certifying drawee against the drawer? On policy grounds, the question ought to be answered in the affirmative; substantively, such a payee's position is no different from that of a payee taker from a remitter.¹⁴⁷ Accordingly, certification must be regarded as the issuance of a new banker's instrument with the drawer being regarded as the remitter, notwithstanding the genesis of the instrument as an ordinary cheque.¹⁴⁸

¹³⁹ See A.W. Rogers, *Falconbridge on Banking and Bills of Exchange* (7th ed., 1969), pp. 625-626. See also Crawford, *op. cit.*, footnote 40, p. 1476. Crawford argues, *ibid.*, pp. 1475-1476, that under "modern concepts of jurisprudence and the administration of justice" the Supreme Court of Canada is not necessarily bound by *Jones v. Waring*. Falconbridge's position side by side with other scholarly adverse views on *Jones v. Waring* affected its disapproval in *Lacasse v. Gratton*, [1963] C.S. 69 (Quebec), as well as in *St. Martin Supplies Inc. v. Boucley*, [1969] C.S. 324, at pp. 325-326 (Quebec). *Jones v. Waring* also was not followed in *Canadian Bank of Commerce v. B.C. Interior Sales Ltd.* (1957), 9 D.L.R. (2d) 363, at p. 369 (B.C.S.C.), as well as in *Dominion Bank v. Fassel & Baglier Construction Co.*, [1955] O.W.N. 709, at p. 711 (Ont. C.A.); *Silberberg v. Menaker*, [1955] C.S. 352, at p. 353 (Quebec); *Central Factors Corp. v. Bragg* (1977), 76 D.L.R. (3d) 585, at p. 587 (B.C.S.C.), albeit without specific reference (in the last three cases). Nonetheless, Canadian courts felt bound by *Jones v. Waring*, for example in *Johnson v. Johnson*, *supra*, footnote 35; *Gallagher v. Murphy*, [1928] 4 D.L.R. 618, at p. 623 (Ont. A.D.), *rev'd.* on other grounds, [1929] 2 D.L.R. 124 (S.C.C.); *Duplain v. Cameron* (1961), 30 D.L.R. (2d) 348, at p. 363 (S.C.C.); and more recently, for example, in *Niagara Finance Co. v. Avco Financial Services Ltd.* (1974), [1975] 2 W.W.R. 352, at p. 355 (Alta. D.C.); *Royal Bank of Canada v. Pentagon Construction Maritime Ltd.* (1983), 143 D.L.R. (3d) 764, at pp. 765-766 (N.B.Q.B.). See also *Mollot v. Monnette* (1981), 128 D.L.R. (3d) 577, at p. 588 (S.C.C.).

¹⁴⁰ See, *supra*, footnote 108.

In fact, historically, the defence-free position of what we call today the holder in due course was not linked to the holder's derivative title, or to taking the instrument by negotiation. The early authorities specifically dealt with the insulation of the payee (to whom the bill was issued rather than negotiated) from defences of the acceptor of the bill of exchange *vis-à-vis* the drawer.¹⁴⁹ However, following *Miller v. Race*,¹⁵⁰ the absolute title of the *bona fide* holder for value has been linked to the transferability or circulation of the paper. The American Uniform Commercial Code turned the wheel back by not requiring the holder in due course to take by negotiation; suffice it for the holder to take the instrument in good faith, for value and without notice of adverse facts.¹⁵¹ A payee may thus be a holder in due course, so as to overcome claims and defences of remote parties.¹⁵² The specific examples given by the Official Comment are not limited to the remitter situation, but also cover instances dealt with in *Lewis v. Clay*, *Herdman v. Wheeler* and *Jones v. Waring*.¹⁵³ Not only does the UCC extend "negotiation" to cover the transfer of an instrument by a remitter to the

¹⁴¹ While talking only of the payee to whom an instrument has been *transferred* as eligible to become a holder in due course, Fletcher Moulton L.J. did not refer *explicitly* to the distinction between "issue" and "transfer", or to the fact that normally an instrument is *issued* (and not transferred) to the payee. *Cf.*, *supra*, text around footnotes 24-25, 68-69. See also, *supra*, footnote 105, at p. 808. It is submitted that the distinction nevertheless underlies his judgment.

¹⁴² See, for example, Ryder and Bueno, *op. cit.*, footnote 40, pp. 232-235. *Cf.* Guest, *op. cit.*, footnote 40, pp. 338-343. A holder for value is a holder who either gave value or who derives his title from someone who gave value. He does not have to comply with holding in due course requirements. See sec. 53(1) (Can.) or 27(2) (U.K.).

¹⁴³ For its possible source see, *supra*, the text around footnotes 97-99.

¹⁴⁴ See, *supra*, the text around footnotes 72-86.

¹⁴⁵ See, *supra*, footnote 100 and sources cited there.

¹⁴⁶ As defined, *supra*, the text around footnotes 63-64. In contrast, the paying party procuring certification of a cheque is in a similar position as the remitter.

¹⁴⁷ In any event the certification by mistake analysis of some Canadian courts (see, for example, those canvassed by Crawford, *op. cit.*, footnote 40, pp. 1794-1795), should be rejected. That is, a payee-holder in due course (or somebody deriving title from him) should be entitled to recover from a certifying bank regardless of the circumstances under which certification was procured.

¹⁴⁸ *Cf.* the view that the certification of a cheque at the holder's request discharges the drawer's obligation and generates a new obligation of the certifying/drawee bank, as expressed in *Boyd v. Nasmith* (1889), 17 O.R. 40 (Ont. C.P.D.), primarily by Street J. in trial, at p. 41.

¹⁴⁹ See *Baker v. Lambert* (1510) and *Grelle v. Lambert* (1513), in H. Hall (ed.), *Select Cases Concerning the Law Merchant* 138 (Vol. 46, Selden Society, 1929), discussed by F.K. Beutel, *The Development of Negotiable Instruments in Early English Law* (1938), 51 Harv. L. Rev. 813, at p. 832. See also Geva, *op. cit.*, footnote 100, p. 84.

¹⁵⁰ (1758), 1 Burr. 452, 97 E.R. 398 (K.B.).

¹⁵¹ Currently, this is provided for in Rev. (1990), UCC § 3-302(a).

¹⁵² See, *supra*, text around footnotes 31-38.

¹⁵³ See cases no. 2, 4, and 3 respectively in Official Comment 4 to Rev. (1990), UCC § 3-302. See also examples c, f/g, and d/e respectively in Official Comment 2 to the pre-1990 UCC § 3-302.

payee; not only does it dispense altogether with the "negotiation" and the derivative title elements of holding in due course; it further extends "remoteness" beyond lack of privity.¹⁵⁴ Under the UCC, "remoteness" also covers absence of direct actual dealings giving rise to the defence attempted to be raised notwithstanding the existence of formal privity. In contrast, inasmuch as the Anglo-Canadian Act does insist on taking by negotiation, the requirement cannot be by-passed. *Vis-à-vis* the acceptor of a bill of exchange, a payee may be treated under the Anglo-Canadian Act as a holder in due course, only by regarding the payee as having a derivative title to the acceptance, namely to the acceptor's debt to the drawer, *as if* an instrument embodying the acceptance (that is, the drawee's engagement to the drawer) has been transferred, namely "negotiated", to the payee. Admittedly, much less imagination is required in order to interpret "negotiation" as including the conferring of a derivative title by the transfer of a banker's instrument from a remitter to a payee.

II. *The Paying Party's Defences Against the Creditor:*

Is Jus Tertii Available to the Issuing Bank?

A. *The Current Law*

A party who broke the contract for which that party took a negotiable instrument cannot be a holder in due course. For the creditor who took a banker's instrument from the paying party, this is so irrespective of whether this creditor is the bearer of a banker's instrument payable to bearer, or the payee or endorsee of a banker's instrument payable to order.¹⁵⁵ Having broken the contract with the paying party, the creditor failed to comply with the taking for value requirement.¹⁵⁶ Likewise, where the breach was carried out knowingly, the creditor cannot be said to have taken the instrument in good faith and without notice. Not having met the statutory requirements, the creditor may thus not be a holder in due course.¹⁵⁷

One not a holder in due course holds an instrument subject to defects of title,¹⁵⁸ that is, to equities attaching to it.¹⁵⁹ According to Chafee, such equities are either equitable *claims* to ownership of a chattel or equitable *defences* to

¹⁵⁴ See, *supra*, text around footnote 60.

¹⁵⁵ For these variations see, *supra*, the text around footnotes 29-37.

¹⁵⁶ See, *supra*, footnote 49.

¹⁵⁷ See sec. 55 (Can.); sec. 29 (U.K.). For holding in due course requirements see, *supra*, the text around footnote 23.

¹⁵⁸ This proposition, which is universally agreed to, is indicated only indirectly by the Act. See, for example, sec. 69(1) and 71 (Can.); sec. 36(2) and (5) (U.K.). For a partial definition of a defective title, see sec. 55(2) (Can.); 29(2) (U.K.).

¹⁵⁹ For the interchangeability of these two terms, see, for example, *Alcock v. Smith*, [1892] 1 Ch. 238, at p. 263 (C.A.). See also Guest, *op. cit.*, footnote 40, pp. 249, 277.

liability on contract,¹⁶⁰ corresponding "to the duplex nature of the negotiable instrument ... [as] both a chattel and a chose in action".¹⁶¹

The remedy of one asserting an equity as to ownership is affirmative, and not defensive, in the form of a claim to the instrument. The remedy of one asserting an equity as to obligation is defensive in nature. This is so even when it is asserted affirmatively in an attempt to enjoin the further negotiation of the instrument to a holder in due course who may take the instrument free from the defence.¹⁶² Stated otherwise, in a negotiable instrument, "[t]he promises and the chattel are inseparable" so that "[t]he right to hold the paper and the right to enforce the obligation are in the same person".¹⁶³ Hence, an equity of ownership affects the title to sue on the instrument. At the same time, an equity of liability is a defence to an action on the instrument; it does not affect the title to sue on it.

Equities of ownership are effectively adverse claims of ownership. A typical claimant is an ex-holder suing in conversion on the basis of either theft,¹⁶⁴ or the negotiation by his successor of title in breach of trust.¹⁶⁵ Alternatively, the ex-holder seeks either to rescind his own negotiation on the basis of fraud or other vitiating factor, or to have this negotiation treated as totally void.¹⁶⁶ Insofar as title to an instrument is necessary for a successful action on it,¹⁶⁷ the successful assertion of equities of ownership undermines the current holder's

¹⁶⁰ "Equities" are claims and defences overcome by a holder in due course under the law merchant, inasmuch as "equities" are overcome by a *bona fide* for value holder of a legal title under general law.

¹⁶¹ See Z. Chafee, *Rights in Overdue Paper* (1918), 31 Harv. L. Rev. 1104, at p. 1109. For the complex nature of the bill or note as a negotiable instrument, chattel and obligation, see A. Barak, *The Nature of the Negotiable Instrument* (1983), 18 Israel L. Rev. 49, a chapter from A. Barak, *The Nature of the Negotiable Instrument* (1972, in Hebrew). As will be seen, *infra*, much of the ensuing discussion has been strongly influenced by Barak's excellent monograph. For some recent judicial endorsement of this complex nature of a bill or note, in the context of the distribution of legislative powers in Canada, see *Red River Forest Products Inc. v. Ferguson* (1992), [1993] 2 W.W.R. 1, at p. 20 (Man. C.A.).

¹⁶² Chafee, *ibid.*, at pp. 1110-1111.

¹⁶³ Chafee, *ibid.*, at p. 1109.

¹⁶⁴ For the defendant in possession of the instrument to be "holder", the instrument must have been payable to bearer.

¹⁶⁵ As, for example, where plaintiff ex-holder had negotiated the instrument for safekeeping to a successor in title who nevertheless negotiated it further, in defiance of plaintiff ex-holder's instructions.

¹⁶⁶ On this point, see the text around footnotes 160-174.

¹⁶⁷ Cf. sec. 138 (Can.); 59 (U.K.), implying that a defect in the holder's title is a good defence to the holder's action. Entitlement on the instrument is included in the pre-Act definition of "holder" in Chalmers, *op. cit.*, footnote 93, p. 3. See also the Indian Act, *supra*, footnote 87, sec. 8; Parthasarathy, *op. cit.*, footnote 88, p. 37, where entitlement to and on the instrument is part of the definition of "holder". But cf. Yudhisthira, Sanjiva Row's *Negotiable Instruments Act, 1881* (9th ed., 1988), pp. 121-122, as to the interpretation of this provision by the courts. Chafee's view, *loc. cit.*, footnote 161, at pp. 1112-1119, that by definition the holder has the legal title, including where he is a thief, should be rejected. Presumably, he was overinfluenced by the analogy between equities overcome by holding in due course under the law merchant and equities overcome by legal title under the general

title to sue on the instrument. This is not so with respect to equities of defences; being defences to liability on a contract, they do not undermine the title to sue on the instrument.¹⁶⁸

Accordingly, the successful assertion of equities of ownership by the paying party against the creditor undermines the creditor's right to possess the instrument and hence the creditor's title to sue the issuing bank. Equities of ownership can thus be used by the paying party also as a basis for an injunction against the issuing bank, restraining it from paying to the creditor who lacks title. This does not apply to equities of defences to liability; by themselves, not undermining the right to possession and hence the title to sue on the instrument, they cannot be used to claim the instrument from the holder or in restraining the obligated bank from paying the holder.

Nonetheless, in some circumstances, contractual defences may be used as a basis to claim an instrument from its holder. This is so where such defences are used by the innocent party to seek specific restitution from the breaching party on the basis of the retroactive cancellation of the contract, or its extinction.¹⁶⁹ Thus, as against the creditor, the paying party may be entitled to restitution on several grounds, such as total failure of consideration (including where goods delivered under a contract for sale are rejected for breach of condition),¹⁷⁰ the rescission (or setting aside) of a voidable contract (for example, for fraud),¹⁷¹ or the treatment of the contract as void *ab initio* (for example, for mistake).¹⁷² The paying party's claim in restitution reflects the retroactive cancellation of his contract with the creditor, and purports to restore the paying party to his or her pre-contractual position. At least in connection with voidable and void contracts, the paying party's claim is for specific restitution and not for the restitution of a sum of money by means of an action for money had and received.¹⁷³ As such, it is effectively a claim for the banker's

law (see, *supra*, footnote 160) erroneously to equate between "holding" and legal title. That is, according to Chafee, to recover, the holder must have a legal title clear of equities. See, *ibid.*, at pp. 1112-1113.

¹⁶⁸ Cf. *Fulton National Bank v. Delco Corp.*, 195 S.E. 2d 455, at p. 457 (Ga. Ct. App., 1973), explaining that "claim", in contrast to "defense", "indicates certain rights in the instrument on which the suit is based rather than mere reasons why the alleged debtor is not liable for the fund".

¹⁶⁹ For the distinction between retroactive cancellation and termination or discharge see, *supra*, the text around footnote 40.

¹⁷⁰ See, for example, A.G. Guest (ed.), *Benjamin's Sale of Goods* (4th ed., 1992), §9-016.

¹⁷¹ See M.P. Furmston, *Cheshire and Fifoot's Law of Contract* (10th ed., 1981), pp. 253-262.

¹⁷² *Ibid.*, pp. 216-228.

¹⁷³ This is less certain in connection with cancellation on the basis of total failure of consideration. Inasmuch as the paying party's consent has not been vitiated by factors such as fraud or mistake, it can be argued that title to the banker's instrument effectively passed to the creditor so that restitution means solely an action for money had and received. But for specific restitution as an appropriate remedy in general for a party entitled to restitution see, for example, G.E. Palmer, *The Law of Restitution*, Vol. I (1978), § 4.7; with a 1982

instrument previously given by the paying party to the creditor, so as to constitute an equity attaching to the banker's instrument.¹⁷⁴

In sum, the retroactive cancellation of the contract may be used by the paying party as an equity of ownership to preclude payment from the issuing bank to the breaching creditor. Otherwise, contractual defences may not be used as grounds by the paying party to preclude such payment.

Two possible limitations on the availability of equities are noteworthy. First, inasmuch as the paying party's right to discharge or terminate the contract with the creditor on the basis of repudiation or fundamental breach does not impinge upon rights and obligations that have already matured;¹⁷⁵ consequently, the exercise of such a right to discharge or terminate the contract by the paying party, unlike the retroactive cancellation of the contract, does not establish an equity affecting the banker's instrument. Second, it is not entirely certain whether rescission and hence the assertion of ensuing equities of ownership is available against a subsequent endorsee, holder not in due course,¹⁷⁶ deriving title from the creditor, where such an endorsee takes the instrument in good faith and for value.¹⁷⁷

So far the discussion was concerned with the ability of the paying party to preclude payment by initiating an action to claim the instrument or to restrain payment on the basis of the paying party's equities of ownership. It will now be considered whether the paying party may preclude payment by the issuing bank to the creditor by simply advising the issuing bank of the creditor's breach.

The right or duty¹⁷⁸ of a party sued on a negotiable instrument by a holder not in due course¹⁷⁹ to meet the action by asserting equities of another (that is,

Pocket Supplement and a 1992 Supplement. See also Restatement of the Law Second, Contract 2d (1981), § 372. Available English authorities provide for specific restitution only where damages do not provide an adequate remedy. See, for example, *Duke of Somerset v. Cookston* (1735), 3 P. Wms. 390, 24 E.R. 1114 (L.C.); *Dowling v. Betjemann* (1862), 2 J. & H. 544, 70 E.R. 1175 (V.-C.). Note however that damages could be inadequate in connection with the banker's instrument, where the alternative to specific restitution is payment to the breaching party (creditor) followed by an action for damages by the paying party! In any event, for the availability of equitable remedies to seize the banker's instrument from a fraudulent creditor, see, for example, Shupack, *op. cit.*, footnote 15, at pp. 476-478.

¹⁷⁴ Having recovered the instrument from the creditor, the paying party may recover from the issuing bank. See, in general, *supra*, the text around footnotes 66-67.

¹⁷⁵ For this point, see Furmston, *op. cit.*, footnote 171, p. 491.

¹⁷⁶ For example, where the holder took an overdue instrument.

¹⁷⁷ A buyer of chattels from a seller with a voidable title gets clear title where (i) the seller's title has not been avoided at the time of the sale, and (ii) the buyer acted in good faith and without notice of the seller's defective title. See, for example, the Sale of Goods Act, R.S.O. 1990, c. S-1, sec. 24. Whether this doctrine applies to bills and notes, or whether it is superseded altogether by the holder in due course doctrine is a difficult question not to be determined here.

¹⁷⁸ It may be a duty towards the equity owner, in the sense that the failure to raise the equity may charge the party sued on the instrument with liability to the equity owner.

¹⁷⁹ Obviously, a holder in due course takes the instrument free from all equities, including those of a third party. For rights of a holder in due course see, *supra*, the text around footnote 21.

third) party has been discussed in the law of bills and notes as *jus tertii*.¹⁸⁰ In our context, the question is whether the issuing bank is either entitled or obliged to meet the creditor's claim by setting up equities of the paying party arising from the breach of contract by the creditor. By paying over such equities, does the bank incur liability to the paying party?

The Anglo-Canadian Act does not deal directly with the *jus tertii* issue.¹⁸¹ In the literature the most comprehensive discussions¹⁸² are by Britton¹⁸³ and Barak.¹⁸⁴ According to Barak,¹⁸⁵ *jus tertii* is available to a defendant sued on a bill or note, provided it is based on equity of ownership and not liability. Payment to the holder with knowledge of third party's equities of ownership does not discharge the instrument and renders the payor liable to the third party equity owner. Barak relies on pre-Act cases, Chalmers' view, and the interpretation of the Act. According to Britton, the statutory provisions are not conclusive.

The pre-Act cases are *Bell v. Lord Ingestre*¹⁸⁶ and *Lloyd v. Howard*.¹⁸⁷ They did not involve banker's instruments. In both cases, the acceptor was sued by an endorsee holder not in due course and in each case, the acceptor had no equities of his own. In the first case, the plaintiff holder did not perform a condition precedent agreed upon between him and his own endorser. As a result, that endorser had an equity of ownership in the bill. In the second case, the plaintiff holder acquired the bill other than as a holder in due course from an endorsee who had endorsed it to the plaintiff in breach of trust *vis-à-vis* that endorser's predecessor. As a result, that endorser's predecessor had an equity of ownership in the bill. In both cases, the acceptor successfully defended the plaintiff's action on the basis of the third person's equities. In reference to these two cases, Chalmers' conclusions,¹⁸⁸ even after the Act, was that whenever an

¹⁸⁰ (Or *Ius Tertii*). So far as I can tell, in this context, the expression was first coined in Chalmers, *op. cit.*, footnote 93, pp. 44, 75 and 185. It was carried over to the 13th edition, *op. cit.*, footnote 96, pp. 61, 102, 108 and 201. The omission of the term in the current edition (Guest, *op. cit.*, footnote 40), is unfortunate as it may serve to downplay the issue.

¹⁸¹ Though it may be interpreted to deal indirectly with the issue. See, *infra*, the text around footnotes 190-199.

¹⁸² Besides Britton, *op. cit.*, footnote 66, and Barak, *op. cit.*, footnote 161, see also Malan, *op. cit.*, footnote 33, para. 216-217, and in greater detail F.R. Malan, Payment in Due Course and the 'Ius Tertii' in South African Law, [1989] J.I.B.L. 24.

¹⁸³ *Ibid.*, pp. 462-477. Britton discussed the question under the American Uniform Negotiable Instruments Law, the predecessor of UCC Article 3, which derived from the English Act.

¹⁸⁴ The question was discussed most comprehensively in Barak's monograph, *op. cit.*, footnote 161, pp. 63-68 (see also pages 48, 62, 71, 73, 121 and 151). Some of the analysis appears (in English) in his earlier article, The Uniform Commercial Code - Commercial Paper. An Outsider's View, Part I (1968), 3 Israel L. Rev. 7, at pp. 21-26.

¹⁸⁵ Between the two, Barak's analysis is the more relevant under the Anglo-Canadian Act.

¹⁸⁶ (1848), 12 Q.B. 318, 116 E.R. 888.

¹⁸⁷ (1850), 15 Q.B. 995, 117 E.R. 735.

¹⁸⁸ For the same opinion by Chalmers also prior to the Act see, *op. cit.*, footnote 93, p. 74.

instrument is held adversely to the true owner, a third party sued on it may set up *jus tertii* against a holder not in due course.¹⁸⁹

So far as availability of the *jus tertii* defence under the Act is concerned, both Barak¹⁹⁰ and Britton¹⁹¹ rely on the section¹⁹² providing that a bill is discharged by "payment in due course", namely payment made "to the holder ... in good faith and without notice that his title ... [to the bill] is defective". It follows from this language that a payment made with notice of the plaintiff's defective title will not constitute a discharge. True, plaintiff's title could be defective on the basis of equities belonging either to the defendant or to a third party; however, as to defendant's payment with knowledge of his own equities, "[t]here would be no point to a statute which told an obligor that if he paid a debt to which he had a defense that his waiver thereof was not binding".¹⁹³ It thus follows that the section speaks of third party's equities, that is, *jus tertii*, and that it effectively allows the defendant to defend plaintiff-holder's claim by setting up that *jus tertii*. That is, if defendant does not get a discharge for payment made with knowledge of third party's equities, defendant may not be compelled to make such a payment. Hence, third party's equities are available to the defendant as a defence.

Nonetheless, according to Britton, this may not be conclusive.¹⁹⁴ Against the availability of *jus tertii*, he cites¹⁹⁵ the section¹⁹⁶ whose Anglo-Canadian counterpart entitles a holder to enforce a bill against any party except for any infant, minor or corporation "having no capacity or power to incur liability".¹⁹⁷ As well, he cites the section providing for the right of a party liable on a bill to pay in disregard of any condition to an endorsement.¹⁹⁸ In Britton's view, these provisions suggest that lack of capacity, and the existence of a condition to an endorsement, as third party's equities do not affect the holder's right to enforce payment.

These arguments are convincingly rejected by Barak.¹⁹⁹ In his opinion, the former provision is of limited application (namely it is confined to the defence

¹⁸⁹ See, for example, Chalmers (13th ed.), *op. cit.*, p. 102. For the omission from the current edition see, the reference, footnote 180.

¹⁹⁰ *Op. cit.*, footnote 161. He also relies on sec. 55(2) (Can.); sec. 29(2) (U.K.), defining "defect of title" in terms which do not exclude third party's equities.

¹⁹¹ *Op. cit.*, footnote 66, p. 467. He also relies on N.I.L., sec. 59 (deriving from sec. 57(2) (Can.); 30(2) (U.K.)), but using a modified language that presupposes availability of equities established subsequent to liability by the defendant.

¹⁹² Sec. 138 (Can.); 59 (U.K.).

¹⁹³ Britton, *op. cit.*, footnote 66, p. 467.

¹⁹⁴ *Ibid.*, p. 468. Heavy reliance was put on American pre-N.I.L. cases.

¹⁹⁵ *Ibid.*, pp. 464-466, 469-471.

¹⁹⁶ N.I.L., sec. 22. See also the preclusions of parties liable on an instrument under sec. 60-62.

¹⁹⁷ Sec. 47 (Aan.); 22(2) (U.K.). See also the preclusion of parties liable on an instrument under sec. 185, 129, 132 (Can.); 88, 55 and 54 (U.K.).

¹⁹⁸ N.I.L., sec. 39, corresponding to sec. 65 (Can.); 33 (U.K.).

¹⁹⁹ *Op. cit.*, footnote 161, pp. 64-66.

of absence of capacity), may speak solely of the transferability of the bill notwithstanding the incapacity of the transferor (who is therefore not liable on the bill), and by negative implication, may indicate that otherwise *jus tertii* is available. As for the latter provision, it does not entitle the holder to recover on the bill notwithstanding the non-fulfilment of the condition; nor does it require the defendant to disregard the condition. Rather, it allows the defendant, at his discretion, to decide whether to disregard the condition or to refuse payment. That is, the defendant is free to raise the non-fulfilment of the condition as a defence to the action.

As to the scope of *jus tertii*, if available to a defendant as a defence to the holder's action, Britton seems to speak only of the availability of third party's equities of ownership, not of liability.²⁰⁰ Barak is even more explicit, and further provides for a rationale. In his view,²⁰¹ *jus tertii* plea is not a defence to the merits of plaintiff's action.²⁰² Rather, it is a challenge to plaintiff's standing to sue. A defendant raising the plea, in effect, argues that plaintiff, having a defective title to the instrument, may not succeed in the action²⁰³ notwithstanding that plaintiff is the holder.²⁰⁴ That is, the defendant effectively pleads that "he promised to pay the ... [instrument] only to the owner of it, and his promise, therefore, does not run to the plaintiff".²⁰⁵ Accordingly, for the defendant to succeed in raising a *jus tertii* plea, third party's equities must be those of ownership;²⁰⁶ third party's contractual defences, unless they are effectively used to cancel the contract retroactively,²⁰⁷ will not suffice. That is, only grounds for third party's intervention²⁰⁸ will justify the assertion of his rights *in absentia*.

In sum, the better view seems to be that under the Act, third party's equities of ownership (*jus tertii*), including those based on the retroactive cancellation

²⁰⁰ Britton, *op. cit.*, footnote 66, pp. 466, 468.

²⁰¹ *Op. cit.*, footnote 161, pp. 67-68 (monograph).

²⁰² But, as Barak points out there, this is not Britton's position. Britton asserts (*op. cit.*, footnote 66, pp. 186-187), that where *jus tertii* is raised against a holder, "just as in the case of the defendant who sets up a defence of his own, the plaintiff is the holder", implying thereby that the availability of *jus tertii* is a question of the existence of a defence against the proper plaintiff rather than that of a standing.

²⁰³ For title as necessary element for a successful action on an instrument see, *supra*, the text around footnote 168.

²⁰⁴ Who may thus sue (but not necessarily successfully) on the instrument. See sec. 73(a) (Can.); 38(1) (U.K.).

²⁰⁵ W.E. Hawkland, Commercial Paper (1959), p. 91.

²⁰⁶ Barak's monograph, *op. cit.*, footnote 161, pp. 67-68, uses the following example to demonstrate the unavailability of third party's equities of defences. Suppose A. drew on B. a bill payable to C. B.'s acceptance was procured by fraud. C. negotiated the bill to D. who took it with knowledge of the fraud so that D. cannot be a holder in due course. In this case, B. has an equity as to liability but is not an adverse claimant to the instrument; at most B. is entitled to receive the instrument temporarily, in order to cancel his signature. If, when sued by D., A. is allowed to raise B.'s *jus tertii*, A. may end up being liable to nobody!

²⁰⁷ Therefore, where the *jus tertii* is based on the voidability of the contract giving rise to the equity, defendant must prove that the contract has been properly disaffirmed. See Chalmers (13th ed.), *op. cit.*, footnote 96, p. 106.

²⁰⁸ See, *supra*, the text around footnotes 169-177.

of the underlying contract, but not equities of defences to liability, can be used not only by the equity owner to preclude payment on the instrument (along the lines of Barak's analysis); they can also form a defence to an action on the instrument against the party liable. The failure to raise a known *jus tertii* defence would expose the party liable to an action by the adverse claimant (equity owner).

Finally, there is the question of standard of proof. Perhaps it can be argued, on the basis of the law of letters of credit in Canada, that in order to obtain an interlocutory injunction restraining the issuing bank from making payment on a banker's instrument, "[a] strong *prima facie* case of ... [equities]"²⁰⁹ must be made by the paying party. On the other hand, where payment has been made, to avoid liability for paying with knowledge of third party's equities, the issuing bank must prove that notice²¹⁰ of adverse equities did not make them "clear or obvious to the bank".²¹¹ The higher standard in the latter case can be rationalized on the basis of "the strict obligation of the issuing bank to ... [pay upon presentment]" as well as on "the fact that the decision as to whether or not to pay must ... be made fairly promptly" and on "the difficulty in many cases of forming an opinion, on which one would hazard a lawsuit".²¹²

B. UCC Article 3 - A Model for Reform?

Subject to narrow exceptions, the drafters of the American UCC opted against the availability of the *jus tertii* defence against an action on a bill or note.²¹³ The starting point of the Code is not different from that of the Act. Thus, under the pre-1990 Official Text, a holder in due course was stated to hold the instrument subject to "all valid *claims* to it on the part of any person", as well as to "*all defenses* of any party which would be available in an action on a simple contract".²¹⁴ These categories correspond to equities of ownership and equities of liability.²¹⁵ So far as *jus tertii* was concerned, it was stated in pre-1990 UCC § 3-306(d) that a holder not in due course takes the instrument subject to "the defense that he or a person through whom he holds the instrument acquired it by theft, or that payment or satisfaction to such holder would be inconsistent

²⁰⁹ *Bank of Nova Scotia v. Angelica-Whitewear Ltd.* (1987), 36 D.L.R. (4th) 161, at p. 177 (S.C.C.) (LeDain J.).

²¹⁰ In general, disqualifying notice must be actual, consisting either of actual knowledge or of a suspicion coupled with a wilful disregard of the means of knowledge. See Guest, *op. cit.*, footnote 40, pp. 274, 492.

²¹¹ *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*, *supra*, footnote 209, at p. 177.

²¹² *Ibid.*, at pp. 177-178.

²¹³ Curiously, Comment 5 of pre-1990 UCC § 3-306 suggests continuity of the "same policy" maintained under the N.I.L., notwithstanding the ambiguity or even controversy (as indicated, *supra*, in text around footnotes 190-199).

²¹⁴ Pre-1990 UCC § 3-306(a) and (b). (Emphasis added). See also §§ 3-306(c) and 3-408 as to the defences of want and failure of consideration.

²¹⁵ This was pointed out by W.D. Warren, *Cutting Off Claims of Ownership Under the Uniform Commercial Code* (1963), 30 U. Chi. L. Rev. 469, note 3. It is consistent with the preceding analysis, *supra*, the text around footnotes 158-168.

with the terms of a restrictive endorsement". However, except for that defence (relating either to theft or restrictive endorsement), it was then stated that "[t]he *claim* of any third person to the instrument is not ... available as a defense to any party liable ... [on the instrument] unless the third person himself defends the action for such party".²¹⁶ That is, unlike under the Act, subject to the theft and restrictive endorsement exceptions, third person's "claims", namely equities of ownership, are not available in an action against a holder not in due course, unless the equities' owner "defends the action" for the party liable.

Pre-1990 UCC § 3-603(1) purported to mirror this provision by eliminating the "payment in due course" concept.²¹⁷ Thus, subject to the theft and restrictive endorsement exceptions, "[t]he liability of any party is discharged to the extent of his payment or satisfaction to the holder even though it is made *with* knowledge of a *claim* of another person to the instrument".²¹⁸ Discharge for such a payment was stated to be denied where prior to such payment or satisfaction (that is, with knowledge of the adverse claim), the adverse claimant "either supplies indemnity deemed adequate by the party seeking the discharge or enjoins payment or satisfaction by order of a court of competent jurisdiction in an action in which the adverse claimant and the holder are parties". That is, the provision allowed the adverse claimant to preclude payment not only by initiating an action (the second option), but also by supplying indemnity (the first option). It thus allowed the assertion of *jus tertii* other than with respect to theft and restrictive endorsement, not only under compulsion by means of an order prohibiting payment (or in connection with an action to which the adverse claimant is joined), but also against indemnity, though at the choice of the party liable, in whose eyes the indemnity supplied by the adverse claimant must be "deemed adequate". In sum, except in connection with theft and restrictive endorsement, inaction by the third party adverse claimant would not allow the defendant to raise the third party's adverse claim as a defence. Injunction or participation in the action by the third party adverse claimant compels the defendant to raise the third party's adverse claim. Indemnity supplied by the third party would be the equivalent of an injunction, but only where it was "deemed adequate" by the party liable. Payment over *jus tertii*, made over an unsatisfactory indemnity (but not over an injunction or satisfactory indemnity) discharges the instrument.

The effective retroactive cancellation of the contract by the paying party, on the basis of that party's contract defences against the creditor, does establish a "claim" (that is, an equity of ownership) in the paying party's hands.²¹⁹

²¹⁶ (Emphasis added).

²¹⁷ See Comment I to pre-1990 UCC § 3-603. For the "payment in due course" concept in force under the Anglo-Canadian Act see, *supra*, the text around footnotes 190-193.

²¹⁸ (Emphasis added).

²¹⁹ See, *supra*, the text around footnotes 169-174. For a previous discussion by this author under the UCC, see B. Geva, Contractual Defenses as Claims to the Instrument: The Right to Block Payment On a Banker's Instrument (1979), 58 Or. L. Rev. 283.

Otherwise, neither § 3-306(d) nor § 3-603(1) of the pre-1990 UCC specifically addressed the availability of third party's "defences" (other than "claims"), namely of equities of liability. It was argued²²⁰ that the scheme was open to three alternative interpretations: (1) "claims" included "defences" (so that third party's "defences" were not available other than where the third party either took part in the litigation or supplied indemnity); (2) third party's "defences" other than "claims" *may* be asserted by the party liable, even without the third party's participation or indemnity; or (3) third party's "defences" other than "claims" *may not* be raised by the party liable, even where the third party participated in the litigation. The first interpretation overlooks the "claims/defences" dichotomy which is premised on the fundamental distinction between equities of ownership and equities of liability. Between the second and third option, the latter is the more plausible. It is more consistent with the pre-UCC background of the issue,²²¹ and the UCC's trend in restricting the *jus tertii* plea. Thus, in the final analysis, third party "defences" other than "claims" may not be raised by the party's liable; this could not be overridden by the third party either supplying indemnity or joining in the action.

The revised (1990) Article 3 reiterates the subjection of a holder not in due course to claims and defences. In some respects it even uses more explicit language, but without introducing substantive changes on this point. First, it specifically speaks of the holder's subjection to "a claim of a property or possessory right in the instrument or its proceeds".²²² This corresponds to "equity of ownership", including on the basis of the rescission of the contract. Second, so far as "equities of liability" are concerned, the holder not in due course is stated to be subject to any contract defence²²³ as well as to "a claim in recoupment of the obligor against the original payee of the instrument" arising from the transaction giving rise to the instrument.²²⁴ Such "claims" do fall into the broader category of contract defences; they are pleas for damages for breach of contract, that could have been pursued in an action against the breaching party, but may be asserted defensively to reduce the amount owing in the action on the instrument.²²⁵ So far, this is in fact a restatement of the position under the pre-1990 Official Text, though with some clarifications.

²²⁰ B.A. Blum, *The Use of Jus Tertii Defenses By an Obligor On a Negotiable Instrument* (1979), 84 Com. L.J. 131.

²²¹ Cf., *supra*, the text around footnotes 200-208.

²²² Rev. (1990), UCC § 3-306.

²²³ Rev. (1990), UCC § 3-305(a)(2). The specific reference to want and failure of consideration (pre-1990 UCC §§ 3-306(c) and 3-408, *supra*, footnote 5) has been deleted.

²²⁴ Rev. (1990), UCC § 3-305(a)(3).

²²⁵ *Ibid.* Comment 3. According to W.H. Loyd, *The Development of Set-Off* (1916), 64 U. Pa. L. Rev. 541, at p. 563, recoupment is "the right to present in opposition to the plaintiff's claim, for its reduction or extinguishment, a right of action in the defendant for loss or damage sustained by him in the same transaction through ... [the other party's] breach of contract or duty". For the broad scope of contract defences, to include those arising where "[e]ach party ... [to the contract] has done wrong ... [so that] each is entitled to a remedy, although there must be an adjustment of remedies", see, for example, A.L. Corbin, *Corbin on Contracts* (1952), § 896.

However, the policy against the availability of the *jus tertii* defence in an action on the instrument is not only clarified but is also expanded in the 1990 Official Text. The principal provision is § 3-305(3)(c). Its basic rule is that in an action to enforce liability on an instrument, "the obligor may not assert ... a defense, claim in recoupment, or claim ... [of a property or possessory right] to the instrument ... of another person". Two exceptions are specifically enumerated. First, "the other person's *claim to the instrument* may be asserted by the obligor if the other person is joined in the action and personally asserts the claim against the person entitled to enforce the instrument". Second, as against one not holder in due course, "[a]n obligor is not obliged to pay the instrument if ... the obligor proves that the instrument is a *lost or stolen instrument*".²²⁶

This scheme is further reinforced by § 3-602. Thereunder, "the obligation ... to pay the instrument is discharged even though payment is made with knowledge of a *claim to the instrument* ... by another person".²²⁷ No discharge will be given only where "payment is made with knowledge by the payor that payment is prohibited by injunction or similar process of a court of competent jurisdiction".²²⁸ In the case of a banker's instrument, the obligated bank is not privileged to withhold payment on the basis of an indemnity supplied by the adverse claimant.²²⁹ Furthermore, the wrongful withholding of payment on a banker's instrument may entitle the holder, under UCC § 3-411(b) not only "to compensation for expenses and loss of interest resulting from the non-payment", but also to the recovery from the obligated bank of consequential damages.²³⁰

In sum, revised Article 3 reinforces the anti *jus tertii* policy of its predecessor by clarifying that only third party's equities of ownership may be raised, and only where the third party is joined in the action. Furthermore, the anti *jus tertii* policy is expanded by the elimination of two exceptions: that of the restrictive endorsement, and more notably, that of the obligated bank's privilege to withhold payment against satisfactory indemnity supplied by the adverse claimant. On the other hand, the theft exception was retained. In fact, it was expanded to cover loss of physical possession not followed by the theft of the instrument.

Under both the UCC and the Anglo-Canadian Act, the distinction between equities of ownership and equities of liability is thus of paramount importance. Under both statutes, equities of ownership include equities generated by the effective retroactive cancellation of the contract for which the instrument was given. Under both statutes, the paying party, as an adverse claimant, may preclude payment on a banker's instrument on the basis of equities of ownership but not equities of liability.

²²⁶ (Emphasis added).

²²⁷ Rev. (1990), UCC § 3-602(a). (Emphasis added).

²²⁸ Rev. (1990), UCC § 3-602(b)(i).

²²⁹ Rev. (1990), UCC § 3-602(b)(ii).

²³⁰ However, consequential damages are recoverable only "if the obligated bank refuses to pay after receiving notice of particular circumstances giving rise to the damages".

Under both the UCC and the Anglo-Canadian Act, the obligated bank cannot defend an action on a banker's instrument by pleading equities of defences to liability belonging to the paying party. The paying party may neither initiate nor be joined in the action against the obligated bank²³¹ on the basis of such equities. However, the two statutes are polarized as to the availability of the paying party's equities of ownership in an action by one not holder not in due course against the obligated bank to which the paying party is not joined. Such equities are allowed under the Anglo-Canadian Act but, with the exception of a stolen or lost instrument, not under the UCC.

C. Some Policy Considerations

Undoubtedly, the departure of the UCC from the position still maintained by the Anglo-Canadian Act reflects the views of Britton.²³² He advances several arguments against the position under which the *jus tertii* defence is available in an action to which the adverse claimant is not a party.²³³ These arguments can be set out as follows:²³⁴

- (1) The availability of *jus tertii* undermines the attainment of discharge by the payor:

even without action against him, a party to a bill or note who has been called upon for payment should be allowed to discharge it by payment to the holder despite the fact that the payor knows the holder has a defective title. The payor should be allowed to terminate the running of interest.^[235] His credit is adversely affected by the circulation of instrument after maturity.²³⁶

Indeed, in a scheme where *jus tertii* is not available (for example, under the UCC), the party liable may pay the holder and obtain discharge without assessing information known to him or her²³⁷ as to the quality of the holder's title. Conversely, where *jus tertii* is available (for example, in Canada), payment to the holder may be upset by the adverse claimant.

²³¹ Obviously the paying party has a cause of action against the breaching creditor on the basis of the equities of defences; but this does not preclude payment by the obligated bank to the creditor.

²³² *Op. cit.*, footnote 66. (See Malan, *op. cit.*, footnote 182, p. 25).

²³³ *Ibid.*, pp. 468-469.

²³⁴ For Britton's concession as to the theft exception see, *infra*, the text around footnotes 249-254.

²³⁵ This particular point may not be applicable to the banker's instrument under which the obligated bank is not liable for interest. On the contrary, having been paid by the paying customer, the obligated bank may wish to hold the funds. Nonetheless, the ensuing sentence is undoubtedly applicable to the obligated bank. *Cf.* the discussion, *infra*, in paragraph containing footnote 247.

²³⁶ Britton, *op. cit.*, footnote 66, p. 468.

²³⁷ But note that even where *jus tertii* is available the party liable incurs no duty to investigate where there is neither knowledge nor suspicion of a defect of title.

- (2) While payment without knowledge of any defect in the holder's title discharges the payor's payment obligation²³⁸ where *jus tertii* is available, such payment does not preclude a subsequent action by the adverse claimant against the payor, in which the adverse claimant alleges knowledge of a defect of title by the payor at the time of payment. The burden of proving lack of knowledge is on the payor.²³⁹ A payor who fails to meet the burden of proof may end up paying twice.²⁴⁰
- (3) Where *jus tertii* is available, having knowledge or suspicion of some adverse facts but not being convinced that the holder has a defective title, a payor may end up paying at the risk of being held, in a subsequent suit against him brought by the adverse claimant, to have paid in bad faith. The payor thus incurs the risk of double payment.²⁴¹ It would not matter if the first payment to the holder was made in satisfaction of a judgment obtained by the holder since the adverse claimant, not having been a party to the litigation, is not bound by that judgment.²⁴² The failure of the payor to prove adverse claim in the first action (brought by the holder) does not preclude the adverse claimant from establishing such a claim in the second action (brought against the payor).
- (4) Where *jus tertii* is available, a party liable on an instrument may end up asserting a defence based on a right belonging to someone who is not interested in raising it. Stated otherwise, "the disposition of the equity of ownership is personal to the owner and it should not be the subject of adjudication in any litigation which will not be binding upon such equity owner".²⁴³ That is, the defendant should not be allowed to override waiver by the third party to whom the equities belong.

Britton's views are not shared by Barak who supports the traditional position (as still maintained under the Anglo-Canadian Act) allowing a defendant to raise *jus tertii* in an action by the holder to which the adverse claimant is not a party.²⁴⁴ In Barak's opinion, the danger of double payment is not serious. Furthermore, precluding the defendant from raising *jus tertii* does not lead to absolute finality of payment.²⁴⁵ As well, unavailability of *jus tertii* leads to

²³⁸ Regardless of whether *jus tertii* is available or not.

²³⁹ This may be a heavy burden for a large organization payor, in circumstances where some knowledge was acquired by someone.

²⁴⁰ Following such a double payment, the payor will sue the holder (to whom he paid first) in restitution.

²⁴¹ "If the instrument has years to run, the same problems repeat themselves with respect to periodic interest payments", Britton, *op. cit.*, footnote 66, p. 468. But this problem does not arise with respect to the banker's instrument.

²⁴² *Quaere* as to whether the first judgment forcing the payor to pay the holder will not bar the payor's claim against the holder in restitution, following the second judgment compelling the payor to pay the adverse claimant.

²⁴³ Britton, *op. cit.*, footnote 66, p. 469.

²⁴⁴ See, *supra*, footnote 184.

²⁴⁵ "Finality of Payment" denotes here an absence of right in restitution. For the use of the term in this sense see, for example, pre-1990 UCC § 3-418.

multiplicity of actions and does not encourage fair dealing in commercial life. With respect, at least in the narrow context of the three participants in the banker's instrument transaction (namely the paying party, the obligated bank and the creditor),²⁴⁶ I am not convinced by Barak's arguments. My reservations with respect to each of the four points made by Barak are set out below.

To begin with, where *jus tertii* is available, the only safe method for the obligated bank to avoid double payment is to withhold payment to the holder whenever it receives any adverse information that may affect the holder's title. This however may be detrimental to the reputation of the bank in the eyes of potential holders, and may force the bank into litigation (initiated by the holder) in which it is not the real party in interest. Indeed, payment by the bank to the holder notwithstanding knowledge of adverse information may equally be detrimental to the reputation of the bank in the eyes of customers and potential paying parties, as well as force the bank into litigation (initiated by the customer) in which it is not the real party in interest.²⁴⁷ Nonetheless, the utility of the banker's instrument as a substitute for cash may be seriously undermined by a consistent policy of withholding payment. Hence, the risk of double payment is not peripheral.

The second objection to disallowing *jus tertii* raised by Barak is that in any event, preclusion does not lead to complete finality of payment. Indeed, also where *jus tertii* is unavailable (for instance, under the UCC), payment by the obligated bank to the holder may not lead to absolute finality since the holder is nevertheless exposed to the paying party's action asserting equities of ownership. Preclusion thus achieves mere partial finality. However, this overlooks the fact that where *jus tertii* is unavailable, so far as the payor is concerned, that party receives an absolute discharge and is not involved in the subsequent litigation between the paying party and the holder. In this respect, the payor's payment effectively achieves finality. Stated otherwise, where *jus tertii* is unavailable, absolute discharge received by the payor should not be outweighed by the achievement of mere partial finality. In fact, where *jus tertii* is available, so that absolute discharge is obviously not achieved, even partial finality does not exist!

Third, there is the argument of multiplicity of actions. Thus, whether *jus tertii* is available or not, liability is ultimately fastened on the breaching creditor. Where *jus tertii* is allowed (for example, under the Anglo-Canadian Act), this may be achieved as a result of one lawsuit, brought by the creditor against the obligated bank, in which judgment is given against the creditor on the basis of the paying party's equities asserted by the obligated bank. Conversely, where *jus tertii* may not be raised (for example, under the UCC), two lawsuits may be necessary. The first is by the creditor against the obligated bank, in which judgment is given for the creditor. The second lawsuit is by the paying party against the creditor for

²⁴⁶ *Jus tertii* policy analysis by both Barak and Britton is general, that is, not in the specific context of the banker's instrument.

²⁴⁷ Nonetheless, such litigation will be avoided where the paying party chooses to sue the creditor (on the breach) and not the issuing bank (that paid the creditor notwithstanding knowledge of adverse information on the wrongful payment).

breach of contract. At first blush, the unavailability of *jus tertii* thus generates multiplicity of actions. Nonetheless, in practice, where *jus tertii* is not available, it is unlikely that the creditor will be forced to bring a lawsuit in order to recover from the obligated bank. It is more likely that the obligated bank will pay the creditor on mere demand. Hence, whether *jus tertii* is permitted or not, liability will be fastened on the breaching creditor following one lawsuit.²⁴⁸ The advantage of the UCC scheme is then that where *jus tertii* is available, litigation is between the real parties to the dispute (namely the paying party and the creditor).

Finally, there is the argument of fair commercial dealing. In Barak's opinion, a rule that requires payment to a holder known to have a defective title does not encourage fair dealing in commercial life. This, however, overlooks the fact that the paying party is given full opportunity to preclude payment by initiating the litigation. A rule which does not permit *jus tertii* does not bypass the concerns of the innocent paying party; the rule merely does not allow the paying party to sit on the fence and avoid litigation on his or her own equities. The rule protects the obligated bank but not at the expense of the paying party. Inasmuch as the innocent paying party may effectively preclude payment to the breaching creditor, no unfair dealing in commercial life is encouraged. To enhance fairness, the law should be amended to allow a paying party, who has notified the obligated bank of his equities, a short period of time to bring his or her lawsuit. During that brief period, payment by the obligated bank should not be allowed. This amendment could easily be implemented in a scheme disallowing *jus tertii*.

In the final analysis, at least with respect to the banker's instrument, Britton's policy analysis is more appealing to me than that of Barak. The position under the Act, under which a *jus tertii* plea is available to a party sued on the instrument is thus inconsistent with the better policies.

Nonetheless, against a thief or one deriving title from a thief, even Britton would allow the party liable to plead *jus tertii*.²⁴⁹ Agreeing with Chafee²⁵⁰ that "the thief would have no standing in court, on grounds of public policy", ²⁵¹ he cites "a fatal weakness in ... [the thief's] own case"²⁵² as the "special reason"²⁵³

²⁴⁸ Indeed, under the Anglo-Canadian Act, as against a hypothetical issuing bank acting in bad faith, the paying party may be forced to bring an action, following the judgment given in favour of the issuing bank against the creditor. Hence, where the issuing bank wrongfully refuses to make payment, two actions are required under both the Anglo-Canadian and UCC schemes.

²⁴⁹ *Op. cit.*, footnote 66, pp. 471-473. Note that Britton argues for this position notwithstanding the fact that he adheres to Chafee's view, (*loc. cit.*, footnote 161) not shared by the present author, as to the legal title of the thief-holder.

²⁵⁰ For Chafee's position as to the availability of the *jus tertii* defence against a thief-holder, notwithstanding the latter's legal title, see Chafee, *ibid.*, at p. 1115. In essence, Chafee, *ibid.*, argues that "the thief would have no standing in court, on grounds of illegality and public policy ... Once the thief gets into the purview of justice, the criminal law cuts across the law of property and nullifies the advantages of his legal title".

²⁵¹ Britton, *op. cit.*, footnote 66, p. 472.

²⁵² *Ibid.*, p. 473.

²⁵³ *Ibid.*, p. 472.

underlying this exception.²⁵⁴ This view, which was adopted by the UCC,²⁵⁵ is however not universally shared, even by those adhering to Britton's general anti *jus tertii* policy grounds.²⁵⁶ However, this point as to the theft exception to the unavailability of *jus tertii* will not be explored further here as it is outside the scope of the present inquiry.

D.

Summary

In sum, the title to a bill or note of one not holder in due course is subject to equities of ownership of third parties. The paying party's claim to a banker's instrument on the basis of the effective retroactive cancellation of the contract with the creditor is such an equity. Under the Anglo-Canadian Act such equities may form the ground of a defence by the obligated bank, even where the paying party is not joined in the litigation. It is the latter aspect which may not be justifiable on policy grounds. Revision along the lines of the UCC (disallowing *jus tertii* unless the third party is joined on the action) is highly recommended. Several improvements could nonetheless be seriously considered. First, whether total failure of consideration is an equity of ownership should be specifically determined.²⁵⁷ Second, the effect of termination or discharge, as opposed to the retroactive cancellation of the contract, should be clarified.²⁵⁸ Third, the position regarding the availability of rescission (and hence ensuing equities of ownership) against a *bona fide* for value subsequent endorsee holder not in due course should also be clarified.²⁵⁹ Fourth, a paying party advising the obligated bank of equities of ownership should be afforded a brief period to submit his or her action, during which the banker's instrument may not be paid.²⁶⁰ Finally, the justification for allowing *jus tertii* based on theft or loss of the instrument should be reconsidered.²⁶¹

²⁵⁴ Conversely, according to Britton, *ibid.*, p. 474, "[t]he position of the finder is stronger than that of the thief because, in many cases he is guilty of no crime, a fact which could well be used to counterbalance the lack of voluntary delivery to him". Hence, according to Britton, against a finder (as opposed to a thief), *jus tertii* ought not to be available.

²⁵⁵ Except that contrary to Britton, *ibid.*, the Revised (1990), Official Text expanded the availability of the *jus tertii* defence to cover loss (and not only theft). The position under the UCC is discussed, *supra*, the text around footnotes 213-231.

²⁵⁶ See, for example, Blum, *loc. cit.*, footnote 220, at p. 141. Acknowledging that "there is nothing attractive about aiding a thief", he nonetheless cannot find it "less attractive than aiding any other person who has acquired the instrument under dishonest or otherwise questionable circumstances". Accordingly, he would prefer a consistent rule disallowing *jus tertii* (even against a thief), so as to eliminate altogether the theft exception.

²⁵⁷ See, *supra*, the text around footnote 170.

²⁵⁸ See, *supra*, the text around footnote 175.

²⁵⁹ See, *supra*, the text around footnotes 176-177.

²⁶⁰ See, *supra*, the conclusion of the paragraph following the one containing footnote 248.

²⁶¹ See, *supra*, the text around footnotes 249-256.

Conclusion

In the hands of a remote holder in due course,²⁶² a banker's instrument is held free from the banker's defences against the paying party as well as from the paying party's claims and defences against the creditor. In turn, a creditor-payee acting in good faith and without adverse knowledge qualifies as a holder in due course so as to overcome the banker's defences against the creditor. At the same time, a creditor-payee in breach of contract with the paying party is not eligible to become a holder in due course.

Nevertheless, even if not a holder in due course, the payee-creditor holds the instrument free from the paying party's contract defences, other than those used by the paying party as claims for specific restitution on the basis of the retroactive cancellation of the contract between the paying party and the creditor. In turn, under the Anglo-Canadian Act, such claims are available to the obligated bank in an action by one not holder in due course, even where the paying party does not use these claims as a basis to an action to enjoin the obligated bank from making payment. Notification to the obligated bank by the paying party of a claim against the payee-creditor is sufficient.

In connection with the banker's instrument, autonomy is thus partially achieved. Indeed, the full implementation of autonomy with respect to the banker's defences is consistent with equity considerations. At the same time, the partial autonomy with respect to the paying party's defences (that is, its inapplicability to claims) reflects the ambivalent policies pertaining to the cash equivalence of the banker's instrument.²⁶³

²⁶² Namely someone who is not a party to the original dealings between the issuing bank and the paying party or between the paying party and the creditor.

²⁶³ See, *supra*, the paragraph containing footnotes 14-15.