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*84 JUS TERTII DEFENSES IN THE LAW OF NEGOTIABLE INSTRUMENTS [FNa1]

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I. INTRODUCTION

The basic principles of the law of Negotiable Instruments were laid down hundreds of years ago, in the decisions of the English courts. Briton sets the time as "By the close of the 1700's." [FN1] What followed was a worldwide modern codification that started with the British Bills of Exchange Act (1882), followed in the U.S. by the Uniform Negotiable Instruments Act, [FN2] which was largely modeled after its British predecessor. [FN3]

There was unusually widespread satisfaction with that legislative product. The English law has been described as "the best act of parliament which was ever passed." [FN4] The English law has provided the basis of the negotiable instruments law of many countries historically related to the *85 British empire. [FN5]

The Uniform Commercial Code [FN6] tried to solve some of the problems that were found in the superb legislation. Despite the compliments the U.C.C. had received, some issues in the law of negotiable instruments remained unclear. One of these concerns the extent to which the law allows parties sued as debtors under a negotiable instrument to raise defenses of the kind known as jus tertii. [FN7]

The law of negotiable instruments deals with a large variety of legal relationship among parties. The almost indefinite negotiability of the instrument can create different sets of obligations running from primary and secondary obligors to other people, namely holders. Section 1-201(20) of the U.C.C. defines a holder as "a person who is in possession of ... an instrument ... issued or indorsed to him or his order or to bearer or in blank."

When the cause of action arises between immediate parties [FN8] most of the cases will be resolved by the law of negotiable instruments in a manner similar to the contractual effect of the underlying obligation as governed by contracts law. The payee has some advantages, mainly in procedural matters and in favorable presumptions, but the defenses against a contractual claim which he could have brought under the underlying obligation would usually also defeat the negotiable instrument claim.

The situation becomes more complicated when a negotiable instrument is negotiated to a third party. The third party, or the fourth, or even further removed parties, usually would not have any contractual relationship with the previous parties (except with the party immediate to him), and in particular not with the principal obligor on the instrument.

A very simple situation can be illustrated by the diagram on the following page.

TABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE

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*86 A, maker, issues a note to the order of B. B, payee, endorses the note to C, indorsee, who becomes a holder. C can usually collect the amount that A has committed himself to pay in the note. [FN9]

In many cases, no problems arise, and A honors his liability. Sometimes, however, A may try to raise a defense, based on the transaction between himself and B, the transaction which as part thereof the note was issued. Most of the law of negotiable instruments deals with the extent to which A can raise the defenses he would have succeeded with if sued by B, when sued by C, a remote party, and with the scope of such defenses. In this, very important, category of cases--it appears that the codifiers can be justifiably proud: The rules are clear, and usually strike a good balance between the interest resulting from the nature of the defense [FN10] and the classification of the plaintiff. [FN11]

However, a third possibility may occur: Under this category A does not deny his liability on the instrument. Furthermore, he does not have any defense of his own and is willing to pay his debt. But A claims that *87 C should not collect on the instrument because of reasons arising from the transaction between B and C. A may say that under that transaction B is entitled to have the instrument returned to him, or that a fourth person, D, was promised the instrument by C and paid C for it. In other words, A says: There is someone else that should be given the instrument so that he could sue me instead of you. This category of defenses is known as "jus tertii": A

raises a defense based on the rights of another party. "May he rely on a defense which does not relate to a defect in the obligation attached to the note but only to the right of ownership of the note?" [FN12]

The jus tertii cases may arise in a variety of factual situations. Using the letter designation above, here are some of them:

1. B negotiated the instrument to C in consideration for a promise. C did not keep his promise to B. C sues A. Can A raise the defense that C should return the instrument to B?
2. The instrument was payable to bearer, and C stole it from B.
3. A knows that C is a trustee for B, and that C intends to take the proceeds for himself.
4. C sold the instrument to D, but did not deliver it to D yet.
5. C obtained the instrument from B using fraud.

Despite the large spectrum of factual situations in which a jus tertii situation may arise, there are very few reported cases in which the courts dealt with such arguments.

This article examines the jus tertii defenses. A preliminary determination will be made as to the exact scope of this subject. The article demonstrates that some of the situations that are dealt with within the jus tertii doctrine should be excluded from it. On the other hand, it argues that it would be hasty to eliminate other situations from the analysis, as has been previously suggested. Having determined the scope, the article moves to examine the jus tertii defense from three points of view. The first perspective is from the law as it stands at present, mainly under the U.C.C., but with some references to the legal system of other countries. The present legal situation is argued to be neither completely clear, nor coherent and logical.

Second, the article analyzes situations involving jus tertii from an economic analysis perspective. The economic model, however, seems not to provide a clearly preferable choice as to the best policy in all the possible cases. The article then examines policy considerations, which lead to a proposal for a legislative amendment to the U.C.C. in light of the policy arguments supplementing the economic model.

II. WHAT IS JUS TERTII, AND WHAT IS NOT

A defense based on jus tertii is one which is founded upon the rights of ***88** another. In raising such a defense, the defendant does not deny liability on the instrument itself ... Rather, he seeks to escape performance of his obligation on the grounds that a right held by someone else in or to the instrument precludes the plaintiff from claiming on it. [FN13]

In order to deal correctly with both policy and economic considerations, it is first necessary to outline the scope of the discussion, namely the appropriate boundaries of jus tertii defenses. The broad definition above, although it appears clear at first sight, can only be used as a starting point, from which it is necessary to move to further clarification. First, the situations that may appear to be within the scope of the doctrine, but which should be excluded from it.

The first sub-category that should be excluded from the jus tertii discussion is the defense that the plaintiff has no legal title to the instrument. [FN14] For example: Smith sues on an instrument payable to Jones, and not indorsed by the latter. The obligation that the defendant has as an obligor is to pay the holder [FN15] and when the plaintiff is not a holder, this is a direct defense, although it may imply that a third person has the right to the instrument, and the defendant is willing to pay him--an argument similar to the defendant's argument when using a jus tertii defense. This was dealt with separately, as a good defense, under the Common Law [FN16] and the N.I.L. [FN17] The U.C.C. not only gives validity to this defense, but, under certain circumstances, almost forces the defendant to raise it, otherwise he may be subject to another claim, and the discharge section will not apply to him. [FN18]

Another sub-category of situations that should be dealt with separately from the jus tertii discussion concerns the situation where the defense in question, although based on an event that occurred between B, the payee, and C, the indorsee, [FN19] has a direct significance on A's liability to B. Assume, for example, that A delivers the note to B upon the condition that it will only be used as a security in the event that A breaches a duty he owes within the underlying obligation, e.g. a security in a rental agreement. If B negotiates the note to C without the condition having first been fulfilled, A may defend himself by proving the non-fulfillment ***89** of the condition, unless C is a holder in due course. [FN20] Although based on an act between two strangers, this defense belongs to the obligor in his own right and is not a jus tertii defense. [FN21] It lacks the main characteristic of a jus tertii defense; the obligor here defends his own interest. [FN22]

A third troublesome sub-category that should be dealt with outside of jus tertii is the capability of a surety [FN23] to defend an action against him, using a defense of the principal obligor towards the plaintiff. This problem arises only in the United States under the U.C.C., [FN24] due to an unfortunate drafting of Section 3-306(d). As will be shown in the next part, this section is the

legal framework for discussing the jus tertii defenses under the U.C.C. In pertinent part, it provides "[t]he claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon unless the third person himself defends the action for such party."

Were it not for the unclear drafting of that last sentence of Section 3- 306(d), the general principles of surety law would have applied. Under these principles, the surety has, among other defenses, [FN25] some defenses which stem from the contract between the obligee and the obligor: [FN26]

By and large, suretyship law has therefore permitted the surety to assert the defenses of his debtor unless the very purpose of the suretyship was to shift the risk of the asserted defense from the creditor to the surety. [FN27]

A literal reading of Section 3-306(d) and the term "third party" that may not exclude a surety, prompted some commentators to suggest that it "appears to abrogate the Common Law rules of suretyship where instruments ***90** are concerned." [FN28] But the majority of the commentators disagree, and some of them "hope and believe that courts will move mountains to avoid reading of the last sentence of § 3-306(d) in such a way." [FN29]

In order to help the courts to move the mountains, two persuasive arguments are supplied. First, it is argued that the draftsmen did not have accommodation parties (and other sureties) in mind when they drafted Section 3-306(d). [FN30] If so, the general surety law would continue to apply under Section 1-103 of the Code. [FN31] A hint to support that argument may be found in the policy argument put forward by the Official Comment 5 to Section 3-306(d), namely because those defenses are "not his the obligor's concern" and are as much for his the third party's protection as for that of the holder. [FN32] This policy basis seems inapplicable in the surety context. This can be easily demonstrated, using the last note I have myself issued: It was in return for an educational loan awarded by Yale University. Before crediting my Bursar account, the university requested that I sign a promissory note, and that someone else would sign as a guarantor. My father added his signature as guarantor. Assume now, that my Bursar account is not credited, but Yale sues me and my father on the note. I can raise successfully the defense of failure of consideration, [FN33] but what about my father? Can it be said that this is "not his concern"? Should the law force him to pay, and then sue me as the principal debtor, leaving me to sue Yale? This does not make much sense, involves administrative costs, and contradicts the policy argument of the Official Comment.

Another argument is that the guarantor in fact asserts his own defense and not that of the principal debtor. [FN34] This argument is parallel in its reasoning to the prior sub-category which was argued not to be a jus tertii defense. [FN35]

There are several variations to this argument, [FN36] all of which try to ***91** avoid the unacceptable and probably unintended repeal of well established principles. Based on any of those arguments, with or without moving mountains, it seems that suretyship should not be dealt with within the jus tertii doctrine. "The proper relationship between the law of negotiable instruments and the law of suretyship has long been troublesome," [FN37] and it seems to be another area in which the U.C.C. failed to make the legal situation any clearer.

My view is that the analysis should include cases in which the plaintiff is a holder in due course. This is not to deny that when this occurs the plaintiff will always prevail, but merely to state that this category of cases should be dealt with within the jus tertii boundaries, in order to present the full picture both as to law and as to the right policy. [FN38] The suggested analysis is based on the various types of holders, and the holder in due course would be a natural end of the spectrum. [FN39]

III. THE USE OF JUS TERTII DEFENSES UNDER THE U.C.C.

Like other defenses, the availability or non-availability of a defense under the U.C.C. is determined in a negative way, by looking at the rights of the plaintiff. Those rights are determined according to the question of whether or not he is a holder in due course. [FN40] If he is a holder in due course, Section 3-305 is virtually the only one derogating his absolute entitlement. Otherwise, [FN41] his rights are narrower, because Section 3- ***92** 306 subjects him to a larger number of defenses.

Consider first the holder in due course. The Code cuts off most of the defenses against a holder in due course. Section 3-305 distinguishes between defenses of "any party to the instrument with whom the holder has not dealt" [FN42] (emphasis supplied) and the residual possibility, the defenses of the party with whom the holder has dealt. [FN43] The defenses of immediate parties are not cut off by Section 3-305. The defenses of remote parties are cut off except for a limited list in Subsection 2.

Some question may arise as to the correct meaning of the word "of." If "of" is used to describe

the authorship of the claim, namely the party who actually raises it, then the allowed defenses, those of the immediate parties, would never be jus tertii defenses. [FN44] On the other hand, if "of" is used as showing belonging, then all the defenses of the immediate party would be available to any remote party (the obligor), a full range of jus tertii defenses. This second interpretation is inadmissible. It would broaden the availability of jus tertii defenses in the wrong place, that is in the case of the holder in due course.

The defenses listed as specifically available to a remote party in Subsection (2) are all defenses of the remote party itself. The language of the Code [FN45] probably bars any broadening of the exception to include jus tertii defenses. [FN46]

The only other possibility is that the plaintiff is a holder, though not in due course. [FN47] In that case, Section 3-306 subordinates the holder to a series of defenses. Paragraph (d), however, goes the other way: Only the first sentence derogates from the rights of the holder, as with the other paragraphs, but the rest of it prevents the defendant from raising some defenses, namely the jus tertii defenses.

Since Section 3-306(d) is the center of the discussion which follows, it is useful to reproduce it here:

3-306 Rights of One Not Holder in Due Course

Unless he has the rights of a holder in due course any person takes the instrument subject to--

***93** (a) ...

(d) 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 with the terms of a restrictive indorsement. The claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon unless the third person himself defends the action for such party.

To put some order in the unusual structure, it would appear that what the section probably does is to set a rule forbidding jus tertii defenses, with four exceptions:

1. Where the holder acquired the instrument by theft.
2. Where someone preceding the current holder in the chain of ownership acquired the instrument by theft.
3. Where payment would be inconsistent with a restrictive indorsement.
4. Where the third party himself defends the action.

The discussion that follow starts with the rule, and then analyzes each of the exceptions.

A serious problem of interpretation, which is very significant to the scope of the permitted jus tertii under the U.C.C., arises from the term "claim," as it was distinguished from the term "defense." Those terms represent, respectively, what Professor Chafee called "equitable claims of ownership" and "equitable defenses to liability." [FN48]

The distinction arises from the duplex nature of the negotiable instrument: It is both a chattel [FN49] and a bundle of contracts. [FN50] The equities of ownership (now called claims) are those related to property rights in the instrument as a chattel, namely the right to restitution of the property. The equities of defense (now called defenses) are equitable defenses to the liability under one (and sometimes more) of the contracts bundled together in the instrument.

With the greatest respect to Professor Chafee and to the unanimous agreement with his distinction by commentators on negotiable instruments, it seems not directly applicable as far as the U.C.C. is concerned. [FN51] A full discussion of the problems in Professor Chafee's analysis ***94** is beyond the scope of this article. In a nutshell, Professor Chafee's distinction probably addresses two separate questions: One is the nature of the claim or defense, as referred to in one or another facet of the duplex nature of the negotiable instrument; the other is the way in which the argument is used, whether in seeking an affirmative remedy (as raised by the plaintiff) or in a defensive way (as raised by the defendant). Although the two questions have bearing on each other, it seems that under the original distinction drawn by Professor Chafee, the first question was merely used as criteria [FN52] to decide the second question. It seems that Professor Chafee was more concerned with the second question. [FN53]

The U.C.C., in the part of Section 3-306(d) describing the general rule of disallowing jus tertii provides "The claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon...." (emphasis supplied). Commentators, most notably Blum, [FN54] have struggled in their attempts to substitute Chafee's distinction into this formula. Does it mean that the section does not bar the defenses of a third party (only claims are not available), and they may be used freely? This literal interpretation cannot stand: It is contrary to the policy expressed in the Official Comment 5 to Section 3-306, [FN55] and protects obligatory rights more than property rights, in a manner inconsistent with other areas of law.

On the other hand, it has been argued that the exception in the last words of Section 3-306(d),

namely that jus tertii defenses will be available if the third party himself defends the action, would be available only when the third party has a claim, but not when he has a defense. A defense would not be available even if the third party interferes. [FN56] For example: If B negotiated the instrument to C within a contract, and following a breach by C, B is entitled to restitution, and wants to intervene, since B's argument is a "defense" according to the classification, he will not be able to intervene.

This argument has no meaning at all under the understanding of Professor Chafee's argument as suggested above. The view that the emphasis should be on the way the claim or defense is used is consistent with the language of Section 3-306(d), and avoids that kind of struggling. A defense is relevant only when the third person is sued, and would usually not be relevant to an action against someone else. A claim, on the other ***95** hand, is an affirmative action, and as such, is relevant when someone else [FN57] tries to realize the negotiable instrument, i.e., to get paid based on the instrument.

The Code seems unclear at this point, thus not resolving the long standing controversy as to the pre-U.C.C. law. [FN58] Codes such as the U.C.C. are expected to put a clear end to legal controversies; but the U.C.C. in fact opened the door for a variety of opposing possibilities, as the preceding and following pages demonstrate.

Another important question is whether within the limited permissible jus tertii area, another limitation exists so that the section is confined to claims and defenses of third persons who are parties to the instrument, or whether claims and defenses of non-party third persons may be asserted as well, within the same boundaries. Two important categories of non-party claims that may arise are:

1. A person may have an equitable claim to an instrument because it is held in trust for him or because it was wrongfully bought with his money. [FN59]

2. The use of special negotiable instruments such as bank money orders, [FN60] traveler's checks, [FN61] cashier's checks [FN62] and teller's checks, [FN63] create a problem because typically in those instruments the underlying obligation runs from the customer to the payee, while the instrument creates a direct liability running from the financial institution to the payee, to which the customer is not a party. [FN64] The customer's order to block payment, ***96** sometimes based on what would have been an acceptable contractual defense at the underlying obligation level, raises the question of the availability of the customer's defenses, to the extent they are permitted by the general jus tertii doctrine, to the bank, despite the fact that the customer is not a party to the instrument.

Blum, having in mind only the second category of cases mentioned above, had difficulties in achieving the desirable interpretation, under which a third person's defense, when permitted, includes also defenses of one not a party to the instrument. He bases this view, rightly, on the language of the paragraph (which distinguishes between "third person" and "third party", and here uses "third person"), and on the examples in the Official Comment, some of which involve claims of non-parties. [FN65] Although the result seems plausible, achieving it might have involved unnecessary difficulties; Blum was bothered by the fact that Section 3-306 and Section 3-603 [FN66] are supposed to mirror each other, and the discharge, he says, has meaning only with respect to the parties to the instrument.

But it appears that this should not have bothered Blum on his way to the right result. First, the mirror relationship between the two sections was not a goal, but rather only a means. The relationship has no value of itself, and the lack of complete symmetry should not lead to any conclusions. Secondly, Blum's starting point, dealing mainly with the second category above, misleads him; the first category, an outside person's claim to the instrument retains the symmetry perfectly: The obligor who pays the holder is protected from a future action by one who has a claim to the instrument, even when the plaintiff was not a party to the instrument. [FN67] Therefore, there are no serious obstacles in arriving at the desirable result; there is no distinction between third party claims according to the third party being or not being a party to the instrument. The topic of "stop payment" orders is widely covered in the legal literature, and is probably the only aspect of jus tertii [FN68] in which there is no further need to elaborate. [FN69]

***97** Turning now to the four exceptions: [FN70]

1. "The defense that he ... acquired it by theft" (On the basic model: C stole the instrument from B):

This exception was needed because it is now quite clear [FN71] that a thief may be the holder of an instrument he stole, when that instrument is either a bearer instrument [FN72] or an order instrument in which the last indorsement is in blank. [FN73] Creating this exception was probably a means of preventing a thief from suing on the negotiable instrument, while keeping the principle of negotiability intact; namely, the thief would still be a holder, but will not be able to

benefit from that by suing on the instrument. [FN74]
Aside from important policy considerations that will be examined further in this article, the theft exception does not raise any problems of interpretation. The term "theft" itself is to be understood in its regular, criminal law, meaning. [FN75] It should probably be construed to include other crimes in which theft is a component thereof, e.g., robbery.
Despite the relatively sharp picture, the answer to one question seems to remain unclear: How, and according to which standard of proof, does the defendant have to prove that the plaintiff is a thief? The problem does not arise when the plaintiff was convicted of theft of that specific instrument. But what if, for some reason, there was no criminal procedure, or even more interesting, there was one, but the plaintiff was acquitted because the judge (or the jury) had a reasonable doubt, that did not amount to favor the "thief" on the balance of probabilities; that is, the court was of the opinion that he is a thief, but he benefitted from the higher standard of proof required in a criminal proceeding? Here, the nature of the claim is civil; does this mean that the applicable standard is the civil standard of proof, or should we require the higher standard of proof applicable to criminal law, since the criminal behavior of the plaintiff is an important component in determining civil liability? Neither the Code nor its commentaries refer to that question, and the answer to it should be determined according to general principles of the law of evidence.
***98** 2. Someone that preceded the plaintiff in the chain of ownerships acquired the instrument by theft (On the basic model, C stole the instrument from B, and negotiated it to D, who is not a holder in due course):
The questions raised above about the thief would be applicable here too. Otherwise, this exception does not raise any legal problems, although its policy implications are troublesome, as detailed below. [FN76]
3. Payment would be inconsistent with a restrictive indorsement
"Restrictive indorsement" is a cluster of different additions to the indorsement, that limit or purport to limit the rights and powers transferred, in the ways specifically provided for in Section 3-205. [FN77] It includes two separate N.I.L. concepts, the conditional indorsement [FN78] and the restrictive indorsement [FN79] making some changes in the law as to each of them. [FN80]
The application and the relevancy of some of the cases that are grouped under this concept to the jus tertii doctrine is unclear, to say the least. For example, the type of restrictive indorsement that "purports to prohibit further transfer of the instrument" [FN81]--has no effect at all in preventing further transfer or negotiation of the instrument. [FN82] Allowing a jus tertii defense based on such restrictive indorsement makes no sense, since there is no merit in that defense itself.
Probably the most interesting and relevant sub-category of restrictive indorsements in that respect are the conditional indorsements. [FN83] The prototype of a conditional indorsement on the basic model is that B, when negotiating the instrument to C, writes: "Pay C, if he delivers to me X." Not paying because payment would be inconsistent with the terms of the conditional indorsement is a classic jus tertii. What this exception probably does is to give full effect to the use of a third party [FN84] claim to the instrument even when that third party does not join the litigation, if the condition was embodied in the written terms of the indorsement.
4. The third party himself defends the action (On the basic model, B joins the action in which C sues A, and argues that he, B, is entitled to receive the instrument back from C.
The most convenient way in which the third party may intervene is after receiving a notice according to the procedure set up in Section 3-803. [FN85] However, this section "is intended to supplement, not to displace, ***99** existing procedures for interpleader or joinder of parties." [FN86] Is the use of the jus tertii defenses according to this exception limited to Section 3-803 interventions? Since the official comment states clearly that the other intervening ways are retained, [FN87] allowing the jus tertii defenses seems crucial to their application.
This exception is probably the most easy to justify, [FN88] both on economic and policy grounds: "The convenience and desirability of avoiding a proliferation of actions." [FN89]

IV. ECONOMIC CONSIDERATIONS

Beware of the conceit that your categories necessarily reflect reality.
Attributed to Max Weber
In the following pages, the analysis of jus tertii events is taken from an economic point of view. This is not an easy task, because while most other areas of law have been dealt with from the economic aspect, the law of negotiable instruments is not even mentioned in most of the basic literature on Law and Economics, [FN90] probably as part of the general poverty in academic writing on negotiable instruments. [FN91] The analysis starts with an examination of the economic features of the negotiable instrument.

The duplex nature of the negotiable instrument has been described above. [FN92] As to the purpose of that odd legal creature, "Negotiable Instruments Law enables the transformation of contractual rights to receive ***100** payment of money into assets approximating money." [FN93] The two main such attributes are (a) the possibility of exchanging the asset quickly and easily for another, because of the general acceptability; and (b) the value of the consideration received for it is not less than the one paid for it. [FN94]

The negotiable instrument is widely accepted as a substitute for money. At first sight it should be worth less than its face value, because the right to receive the specified amount of money, is reduced by two factors:

1. The cost of collecting a check is reflected in the various commissions and service charges, the time and effort spent in the deposit process. In the case of an instrument that is a substitute for immediate payment, [FN95] the recipient also forgoes the time value of money between the initial payment time and the end of the collection process. [FN96] It may be argued that this derogating factor may be avoided by negotiating the instrument immediately, for value. However, the theoretical question remains the same, why should the transferee pay the face value of the instrument, when his rights suffer from that derogation?

2. The instrument bears with it a collection of various risks that the holder will not get his money. The complete list of those risks vary according to the specific factual situation, but some of the most important are insolvency of the obligor after issuance of the negotiable instrument and before payment, disappearance of the obligor, and so forth. [FN97]

Why, given these, are people willing to take a negotiable instrument as a substitute for cash at its face value? First, actually not everybody does. Many people and businesses refuse to accept payment by personal checks; others try to minimize the risk in various ways: by requiring proper identification, possession of credit cards or check guarantee cards, or by accepting checks only from familiar customers. Second, the payee benefits from advantages of the check, mainly safety when carrying large amounts of "money", and, even more important, he offers a method of payment that is convenient to prospective customers, like any other convenience offered to promote the creation of contracts between them. For someone who values the benefits as being equal to, or greater than, the ***101** cost of collection plus the risk of no collection, it is worth accepting negotiable instruments as a substitute for money. [FN98] Between commercial parties, e.g., merchants and financing companies, these risks are reflected in the discounted sum of money that the merchant receives. [FN99] This view of the negotiable instrument should serve as the starting point for a "functional-policy" analysis. [FN100]

In order to achieve its function as a money substitute, the negotiable instrument should be treated as much as possible as if it was a bag full of money in the amount of the instrument's face value. This goal may be achieved by cutting off as many defenses as possible. It should not be a final allocation, i.e., it should not prevent the buyer from getting his money back, but it should make the initial entitlement similar to the case in which the buyer paid with a bag full of cash: He could still sue for his money back, but the money is in the hands of the seller, and the burden to sue is on the buyer- obligor. Thus, the initial tendency should be to disallow defenses, unless there are other considerations, arising from economic or other considerations, that outweigh bringing the negotiable instrument as close as possible to money. [FN101]

Several well developed areas of the discipline of Law and Economics may be candidates to be applied in the case of negotiable instruments. The first, are Law and Economics techniques in respect to contracts. As was mentioned above, one facet of the duplex nature of a negotiable instrument is a bundle of contracts. In application to negotiable instruments, it seems attractive to favor legal rules under the "gap filling" theory, and the rules should reflect what the parties would have agreed to, if they could have negotiated costlessly. [FN102] The argument that those rules should be adopted, according to efficiency considerations seems even stronger in the negotiable instrument environment, in which negotiation among all the prospective parties is not only costly, but rather impossible. However, this is also one of the two reasons why economic analysis of contracts cannot assist us much: The theory of gap filling has, as one of its cornerstones, the dispositive nature of the rules, namely the freedom for the parties to reject any rule that does not fit their specific ***102** efficiency concept or any other goal they may have. Once this possibility is removed, it seems that the gap filling theory cannot stand, at least not on a narrow efficiency basis. [FN103] Any attempt here may create rights, against the parties will, and with no way to avoid their application, since negotiation is impossible outside of the immediate parties context.

A second problem in applying the economic analysis of contracts is that negotiable instrument litigation, and specifically jus tertii cases, frequently involve a wrongdoer, i.e., a thief, a swindler, etc. Policy considerations encourage a rule against wrongdoers, and the underlying application of rules as substitutes for cooperative selection of efficient rules does not apply.

Another candidate for application are the concepts from the economic analysis of torts. Some negotiable instrument rules seem to reflect torts concepts, especially the idea that he who could prevent a dangerous situation is liable for the results, even if he did not consent to bear that liability. This is well demonstrated in the case of a completed and signed instrument, stolen from its maker; a holder in due course takes it free of the claim to restitution and of the defense of non-delivery. [FN104] However, trying to transplant the well-developed concepts of economic analysis of torts into the negotiable instrument area does not seem to fit, probably because of the very different subject matter.

Taking that starting point, that defenses should not be allowed unless there is a policy-based argument to allow a specific defense, the jus tertii cases may be formulated into a simple model, based on the simple situation drawn at the beginning of this article: A, the maker, issues a note to the order of B. B, the payee, endorses the note to C, indorsee, who is also a holder. C sues A, but A raises a defense based on the transaction between B and C, for example failure of consideration in that the consideration that C gave B was worthless.

At this point--two possibilities arise:

1. A chain of actions would follow. In this example, C collects upon the instrument from A (assuming that jus tertii defenses are not available to A), but B sues C under their contractual relationship, and the proceeds of the instrument end up in B's hands. This is the correct result, but it is inefficient because two legal proceedings took place instead of one, hence increasing transaction costs. In more complicated cases than the simple example the number of litigations can be much larger.

The costs arising from proliferations of actions seem to be a sufficient reason to withdraw from the general principle of disallowing defenses. ***103** This simply means that the existing exception that jus tertii defenses are available when the third party himself defends the action [FN105] should be maintained. It would be efficient, therefore, to allow the third party's intervention in as broad a range of situations as possible. [FN106] That means that the third party should be allowed to intervene as easily as possible and with the largest variety of valid claims as possible, including claims based on the contractual nature of the instrument ("defenses"). [FN107]

2. A chain of actions would not follow for a variety of reasons, some of which will be described later in the analysis. Under this possibility, the person really entitled to receive the proceeds of the instrument, B, is not getting them, at least not now. Instead, allowing A to raise jus tertii defenses means that the obligor (A) gets a windfall; he does not pay on the instrument, although he received consideration in order to assume liability on it. Disallowing the jus tertii defenses, on the other hand, means that the holder, C, gets a windfall; He gets to collect on the instrument, although he did not pay for it and/or should have returned it to B. The analysis here is, hence, an unusual one: Not who should bear the risk, but who should get a windfall. [FN108] C is not always a wrongdoer, as the analysis in the following section will demonstrate.

There does not seem to be an economics-based answer to the question who should prevail in such a scenario. The answer may be sought for in non- economic policy considerations, retaining this section's conclusions as background.

V. LAST STEP: POLICY

The model left us with two candidates to receive the windfall. The only way to decide between them is to try to classify them. If for policy reasons we are more sympathetic towards one of them, that party should prevail. If there is no reason to prefer one of them, then, among equals, the cut-off of defenses policy (based on the economic nature of the negotiable instrument) should tip the scales for the plaintiff.

Of the two characters, the primary obligor, the maker, seems to be "sympathy neutral." That is, nothing that he did or any categories of which he may be part may change our view of him. [FN109]

***104** This, however, is not the case of the holder; throughout the law of negotiable instruments holders are distinguished according to some personal characteristics. At one end stands the holder in due course, [FN110] to whom the law of negotiable instruments gives as many rights as possible. On the other end, stands the wrongdoer, since even a thief can become the holder of an instrument he stole. [FN111] Other categories are the bona fide purchaser for value, the holder for value, [FN112] and the holder that did not give any value.

The holder in due course should prevail in jus tertii situations. Policy considerations should favor the holder in due course wherever possible, in an effort to encourage negotiability. Everyone knows that if he or she just fulfills the requirements to become a holder in due course--something that is not so hard--almost no defenses would be available against him. In the rare circumstances in which a jus tertii claim may arise against a holder in due course [FN113] disallowing the claim does not give him a windfall, and allowing the claim leaves him with an

unjustified loss. [FN114]
No jus tertii defenses should therefore be allowed against a holder in due course. This result is compatible with the actual situation under the U.C.C. [FN115]
It appears that the same analysis could apply to a bona fide purchaser for value. The only difference between a bona fide purchaser for value ***105** and a holder in due course is that the former does not fulfill the requirement in Section 3-302(1)(c), that he takes the instrument "without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person." Such notice may arise under a very wide variety of circumstances, as detailed in Section 3-304. Most, if not all, of them do not seem to provide any reason to punish the holder by preventing him from collecting on the instrument he has purchased in good faith. This result is different from the situation under the U.C.C.. Since he is not a holder in due course, the bona fide purchaser for value is treated under Section 3-306(d), and is subject to jus tertii defenses when one of the exceptions occur. But are the relevant exceptions [FN116] justified under those circumstances?
In order to deal with the exception that someone preceding him in the chain of ownership acquired the instrument by theft the basic example used throughout this work needs to be extended: A, the maker, issues a note payable to the bearer and delivers it for value to B. C steals the note from B, and then negotiates it to D, the bona fide purchaser for value, who does not qualify as a holder in due course. [FN117] If B interferes in the action, a conflict arises between B and D who both paid for the instrument, and A, of course, should not pay both of them. But in the second category of cases, when B himself does not interfere, the conflict is between allowing the jus tertii defense, which would result in giving A a windfall, while leaving D without the valuable instrument he has paid for, [FN118] or letting D collect. Under the latter possibility, every one gets what he bargained for, except for the thief who is enriched on the account of B; the same result that would have occurred if the thief stole a bag of money from B instead of an instrument. The latter option clearly leads to a better result, so that a bona fide purchaser for value should be immune from the jus tertii defense that he acquired the instrument through a thief, unless the victim of the theft joins the action.
***106** The other relevant exception occurs when payment is inconsistent with a restrictive indorsement. As was demonstrated above, [FN119] the U.C.C. allows jus tertii defenses when the defense is embodied in the written terms of the indorsement.
This exception is explained in a very strange way. The Official Comment 5 to Section 3-306(d) says:
The exception concerning restrictive indorsements is intended to achieve consistency with § 3-603 and related sections.
But examination of the policy behind the exception in Section 3-603 does not provide much assistance: "These provisions are thus consistent with § 3- 306...." [FN120] Consistency is certainly important, but consistency with an erroneous policy is not desirable. The policy argument behind the general rule of disallowing jus tertii, as described above, contradicts that result, as does the general policy argument made in the Official Comment 5 to U.C.C. Section 3-306: "He (the obligor) usually would have no satisfactory evidence of his own on the issue...." Therefore it appears that the restrictive indorsement exception should be repealed in all cases, including, of course, the case of a bona fide purchaser for value. [FN121]
Under current law, the obligor, if he knows about the problem in the contractual obligation embodied in the restrictive indorsement so that he cannot be presumed to pay in good faith, is forced to raise the defense based on the restrictive indorsement, because if he pays inconsistently with it, he is not discharged by his payment [FN122] and may be required to pay again to the restricting indorser. This result is totally unjust, and puts an enormous burden on the obligor, who in most cases is not at all concerned with the relationship between B and C. The mere fact that he knows should not shift the burden to him: first, C also knows that the condition was not fulfilled, and B, who wrote the condition when he indorsed the instrument, probably can know himself if it was satisfied. Second, there is a difference between knowing something and having the tools to prove it. A may know, but why should he bear the cost of evidence and litigation for a transaction he has nothing to do with? A would be much worse off than he would be if he paid in cash, instead of using an instrument. In order to achieve consistency the repeal of the jus tertii exception should be accompanied by a compatible adjustment to the discharge provision. [FN123]
***107** From here on, the article assumes a plaintiff that is a wrongdoer. For the purposes of this analysis, the term "wrongdoer" would include those who acquire the instrument in a way that by itself is criminal, and entitles the victim to restitution. Under the U.C.C., the only wrongdoer against whom a jus tertii defense may be raised is a thief. This is not just an example; the Official Comment states very clearly that this was the intention, and that in the case of fraud, for

example, jus tertii defenses are not available. [FN124]

It has been argued persuasively that there is no reason to distinguish between theft and other wrongdoing. Referring to the rule that, unlike other wrongdoers, a thief has no legal title to the instrument he has stolen, Professor Chafee wrote:

It is high time to stop being squeamish about this. Other bad men are admitted to have legal title to negotiable instruments and sometimes to chattels as well--defrauders, absconding trustees, impersonators. [FN125]

Professor Britton argues that there may be a difference; the theft case is surreptitious acquisition of possession, and all the other cases involve a voluntary transfer of possession. [FN126] But "this argument is unconvincing. The voluntary nature of the transfer is no more than a form." [FN127]

Concluding that there is no serious reason to make a distinction between the thief and the other wrongdoers does not necessarily lead to an unequivocal conclusion. A decision is still required whether to give effect to the policy of excluding as many defenses as possible when a negotiable instrument is involved, in order to bring the instrument as close as possible to the situation of money, or alternatively to prevent all wrongdoers from collecting on the instrument, because "The social goal served by refusing to permit the criminal to profit by his crime is greater than that served by the preservation and enforcement of legal rights of ownership." [FN128]

Even commentators like Professor Chafee who favored the approach that would allow a thief to acquire legal title, looked for means of blocking him from collecting on the instrument. In fact, Professor Chafee suggests ***108** the jus tertii defenses as the primary means of blocking a thief from collecting. [FN129] This seems to be the only available method of achieving the social goal, even at the price of allowing a defense and derogating something from the negotiability. One cannot rely only on the criminal law system in such cases, as is demonstrated from the following example:

The thief stole the bearer instrument from an unknown individual, so that individual cannot be asked to join the action. The thief remains in a country which has no extradition treaty with the U.S., and a lawyer sues the obligor on his behalf: "My client, who stole that instrument...."

This is a case in which a windfall to the obligor is preferable, to letting the thief walk away with the fruits of his wrongdoing. If there is any chance at all that the true owner, the victim, will one day get paid, it is only by letting the obligor raise a jus tertii defense. This may be supplemented by a procedure under which the money is deposited with the court, awaiting its true owner, but such a rule waives any incentive [FN130] the obligor may have to raise the wrongdoing jus tertii defense, and to bear the litigation costs accompanying it. However, the instrument itself, in the case of a successful jus tertii defense of that kind, should be deposited in the court, and not given to the obligor, and certainly not to the wrongdoer.

We are left with the holder who does not amount to a bona fide purchaser for value, and of course is not a holder in due course. Under the U.C.C. such a holder would be entitled to recover on the instrument, unless the instrument was acquired through a thief. Probably this exception under the U.C.C. is based on the current legal rule in the United States which provides that a transferor can convey only those property rights that he legitimately has, as applied to the negotiable instrument. However, even if that rule is justified, [FN131] a well settled exception to it is that a thief can convey good title to money. [FN132] Should the negotiable instrument be treated as money? At least in the case of the holder in due course, this is what has been done, and a holder in due course has clear legal title in a stolen instrument.

However, when dealing with someone whose position does not amount to the position of a bona fide purchaser for value, serious suspicions arise that he may be an accessory of the wrongdoer. This suspicion becomes ***109** even greater when one takes into account the fact that the existence of any holder in due course in the chain of possession between the holder and the wrongdoer gives the holder the rights of a holder in due course, [FN133] which would have left him outside of the present discussion. Therefore, despite hesitations, a rule that accepts jus tertii defenses based on the existence of a wrongdoer in the chain of possession seems more favorable, when the plaintiff does not qualify as a bona fide purchaser for value. The windfall here would go to the "sympathy neutral" individual, and not to one who we have good reason to be suspicious of and little incentive to favor.

Finally, if the jus tertii defense is not based on the criminal behavior of the plaintiff or a former holder, the result should be different even in respect of a simple holder. The classic example here is the contractual claim of mistake by the third party. In the relationship between the mistaken indorser and the indorsee, this may be a good cause of action to discharge the contract; but unless the third party indorser joins the action--this does not appear to be a valid reason for allowing a jus tertii defense.

VI. CONCLUSIONS

The scope of the jus tertii defenses allowed under the U.C.C. is unclear. The policy behind what is understood to be the present state of the law is correct with respect to the holder in due course, but inconsistent and not always correct with respect to other holders. The normative framework to deal with is Section 3-306(d). The views expressed in this article may be summarized in the following proposal for a new paragraph (d): [FN134]

(d) The claim or defense of a third party is not available to the obligor unless--
(1) The third party himself defends the action for the obligor; or
(2) The third party claim or defense raised is based on the plaintiff having acquired the instrument in a manner that constitutes a crime; or
(3) A person through whom the holder holds the instrument, acquired it in a manner that constitutes a crime, unless the holder himself acquired the instrument in good faith and for value.

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This article is dedicated to the memory of my late grandfather, Robert Sommer, a man who dedicated his life to protecting literal jus tertii, the rights of others.

[FN1]. W. Britton, Bills and Notes 9 (2d ed. 1961).

[FN2]. (Commonly known and hereinafter referred to as the N.I.L.) The N.I.L. was promulgated by the National Conference of Commissioners on Uniform State Laws in 1896, and by 1924 was adopted with only minor variations in all states. See the legislative history of the N.I.L. in Britton, supra note 1, at 9-15.

[FN3]. C. Weber and R. Speidel, Commercial Paper 3 (3d ed. 1982).

[FN4]. MacKinnon L.J. in Bank Polski v. Mulder [1942] 1 All E.R. 396, 398. However, this compliment and others like it that were awarded both to the British Act and to the American N.I.L. have been criticized by some commentators. See, e.g., Chafee, Remarks on Restrictive Indorsements, 58 HARV.L.REV. 1191 (1948).

[FN5]. For a list of those countries see Barak, The Uniform Commercial Code--Commercial Paper: An Outsider's View, 3 ISR.L.REV. 7-8 (1968); 1 D. Cowen and L. Gering, The Law of Negotiable Instruments in South Africa 119 (5th ed. 1985) (hereinafter: Cowen).

[FN6]. (Commonly known and hereinafter referred to as the U.C.C..) For a history of the U.C.C. see J. White and R. Summers, Uniform Commercial Code 1-6 (3d ed. 1988). To date, the U.C.C. has been adopted by all the states except Louisiana. Louisiana has adopted the U.C.C. articles relating to negotiable instruments, namely Articles 3, 4 and 7.

[FN7]. The term "jus tertii" (Latin for "right of a third party") is also used in other areas of the law. In England it is a defense that may sometimes be raised by a party who is sued in respect of property, and also a defense against a tort action in conversion under the Torts (Interference With Goods) Act 1977; see E. Martin, A Concise Dictionary of Law 199 (1983); Jeffries v. G.W. Ry. Co., 119 E.R. 680 (1856). In the United States the term has been used within the doctrine of standing in constitutional law cases, when the petitioner acted on behalf of someone else's rights. See, e.g., Eisenstadt v. Baird, 405 U.S. 438 (1972); Sedler, Standing to Assert Constitutional Jus Tertii in the Supreme Court, 71 YALE L.J. 599 (1962). Professor Barak raises doubts as to the use of the term jus tertii in the negotiable instrument context. See Barak, supra note 5, at footnote 5.

[FN8]. Immediate parties may, for example, be the payee and the maker of the note, or the

acceptor and the payee of a draft.

[FN9]. B would have some secondary liability towards C in the event that A does not pay. See U.C.C. § 3-414.

[FN10]. An example of a defense is the failure of consideration.

[FN11]. The plaintiff may be a holder in due course, holder bona fide for value, holder for value, holder, or a non-holder.

[FN12]. Barak, supra note 5, at 22.

[FN13]. Blum, The Use of Jus Tertii Defenses by an Obligor on a Negotiable Instrument, 84 COM.L.J. 131 (1979).

[FN14]. Cf. Palmer, Negotiable Instruments Under the Uniform Commercial Code, 48 MICH.L.REV. 283 (1950). See Blum, id., at 136.

[FN15]. U.C.C. § 3-301. See also infra note 41. For a definition of the term "holder" see text following supra note 7.

[FN16]. Note, Jus Tertii under the Common Law and the N.I.L., 26 ST. JOHN'S L.REV. 135, 139 (1951); Hayes v. Hathorn, 74 N.Y. 486; Bond v. Maxwell, 40 Ga.App. 679, 150 S.E.2d 860 (1929).

[FN17]. Britton, supra note 1, at 463. Britton calls that "a type of jus tertii," but deals with it separately.

[FN18]. See U.C.C. § 3-603.

[FN19]. The letter identification refers to the illustration at the text accompanying supra note 9.

[FN20]. A may even prove his defense by parol testimony. See Britton, supra note 1, at 128. A holder that is not a holder in due course takes the document subject to this kind of defense. See U.C.C. § 3-306(b).

[FN21]. Blum, supra note 13, at 139.

[FN22]. Compare text accompanying infra note 13.

[FN23]. The term surety is the subject of differing views regarding its scope under the law of negotiable instruments. See, e.g., the very broad definition of F. Ryder and A. Bueno, Byles on Bills of Exchange 442 (11th ed. 1988) (hereinafter: Byles). In the U.S. there seems to be a significant consensus that both an accommodation party (U.C.C. § 3-415) and a guarantor (U.C.C. § 3-416) should be dealt with as a surety, although their origin is very different. For an even larger list of sureties, see Peters, Suretyship Under Article 3 of the U.C.C., 77 YALE L.J. 833, 837 (1968) (hereinafter: Peters).

[FN24]. In England the surety can plead personal defenses belonging to the principal debtor, and the legal discussion of the subject has nothing to do with jus tertii. See Byles, supra note 23, at 447. In Israel, § 57 of the Negotiable Instruments Ordinance [new version] created a different set of liability rules for the surety; Y. Sussman, The Law of Bills of Exchange (4th ed. 1967) ch. 14.

[FN25]. For a general description of the defenses available to a surety, see F. Hart and W. Willier, 2A Bender's U.C.C. Ser. (Bender), §§ 13.15-13.18 (hereinafter Hart and Willier).

[FN26]. Restatement of Security, §§ 117-26 (1937). Well settled and justified exceptions are the defenses of infancy, incapacity and bankruptcy. See Restatement, id., White and Summers, supra note 6, at 594-95.

[FN27]. Peters, supra note 23, at 862.

[FN28]. Blum, supra note 13, at 139.

[FN29]. White and Summers, supra note 6, at 597. See also Lawrence, Misconceptions About Article 3 of the Uniform Commercial Code: A Suggested Methodology and Proposed Revisions, 62 N.C.L.REV. 115, 141-42 (1983).

[FN30]. Id.

[FN31]. Section 1-103 reads:
Unless displaced by the particular provisions of this Act, the principles of law and equity ... shall supplement its provisions
The law of suretyship is not specifically included in the legal areas listed in that section, but the Official Comment 3 states: "The listing given in this section is merely illustrative."

[FN32]. See Chemical Bank of Rochester v. Ashenburg, 94 Misc.2d 64, 405 N.Y.S.2d 175, 178-79 (Sup.Ct.1978).

[FN33]. U.C.C. § 3-408.

[FN34]. E. Peters, A Negotiable Instrument Primer 64 (2d ed. 1974) (hereinafter: Peters-Primer).

[FN35]. See text accompanying supra notes 19-22.

[FN36]. White and Summers, id.; Peters, supra note 23, at 865; Hart and Willier, supra note 25, §§ 13.17-13.18.

[FN37]. Peters, supra note 23, at 836.

[FN38]. Britton, supra note 1, at 462, takes the view that the discussion should not include the holder in due course, but only the other possibilities, namely: "[w]hen the plaintiff is the wrongdoer against whom the right of restitution could be successfully asserted by the third party or when the plaintiff is the purchaser with notice from the wrongdoer, or when he is the donee in good faith, or is a purchaser in good faith after maturity from or through the wrongdoer or is an innocent purchaser of the possession of an instrument for which there is an outstanding legal title in a prior party." This view is a pragmatic one and fits well into Britton's book. For purposes of academic discussion, however, this article chooses a different view.

[FN39]. See text accompanying infra note 107.

[FN40]. Section 3-302 states:

§ 3-302. Holder in Due Course.
(1) A holder in due course is a holder who takes the instrument
(a) for value; and
(b) in good faith; and
(c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person.
(2) ...

[FN41]. Some question may arise, because Section 3-306 is not limited in application only to holders, and rather uses the term "taker." For a similar terminology under Section 3-415(2), Professor Peters has argued that the term taker "presumably is intended to include those physically in possession of a negotiable instrument who do not qualify as holders." Peters, supra note 23, at 844. In respect of the situation in which it was raised this argument seems strange: Section 3-415 does not deal with a mere taker, but with a taker for value. Taking for value is defined in Section 3-303, and may be done only by a holder. For the purposes of Section 3-306, however, this question has no real significance: Section 3-306 does not award substantive rights, which are awarded by Section 3-301 ("The holder ... may ... enforce payment ..."); See Goldberg v. Rothman, 66 Misc.2d 981, 322 N.Y.S.2d 931. All that § 3-306 does is to derogate from those rights, so that it is relevant only to a holder. The Official Comment also uses the term "holder."

[FN42]. Hereinafter remote parties.

[FN43]. Hereinafter immediate parties.

[FN44]. They would always be, when used by a remote party, "of" the obligor who raises them, and limited to § 3-305(2) exceptions. See Blum, supra note 13, at 140.

[FN45]. "The party," "the transaction" (emphasis added).

[FN46]. Blum, id. An example would be to claim that one of the causes in Subsection 2 (e.g., incapacity, infancy, etc.) exists as to a party between the plaintiff and the defendant.

[FN47]. When the defense is that the plaintiff does not qualify as a holder it is not a jus tertii defense. See text accompanying supra notes 14-18.

[FN48]. Chafee, Rights in Overdue Paper, 31 HARV.L.REV. 1104, 1109-10 (1918). "Professor Chafee's exhaustive study and penetrative analysis of the overdue paper is well known ... the contribution which Professor Chafee here makes to an understanding of a fundamental conception in the law of negotiable paper--goes way beyond the specific with which he is concerned...." Britton, supra note 1, at 456.

[FN49]. "Always available for framing or even papering the wall, for which purpose unlucky investors have used their coupon bonds." Chafee, Id. at 1109. For an analysis of the legal consequences of the proprietary nature of the negotiable instrument, see Barak, The Nature of the Negotiable Instrument, 18 ISR.L.REV. 49, 53-60 (1983) (hereinafter: Barak-Nature).

[FN50]. "The duplex nature of a negotiable instrument, this piece of property from which depend numerous obligations running in different directions always reminds me of a jelly-fish with its streamers." Chafee, Id. at 1110.

[FN51]. The U.C.C., of course, did not exist when Professor Chafee wrote his celebrated article.

[FN52]. The criteria does not seem a perfect one. Most of the criticism is pointed towards those who took a distinction that was prepared for a special purpose and under the law of a specific time, and transplanted it into modern legislation, with respect to a different issue. See Blum, supra note 13, at 132; cf. Chafee, id., at 1110.

[FN53]. Chafee, id., at 1109-11. See also Weber and Speidel, supra note 3, at 258: "In general a defense is asserted negatively as a shield to protect one against being subjected to liability, whereas a claim is asserted affirmatively as a sword to impose liability on someone else."

[FN54]. Supra note 13, at 131-36.

[FN55]. Id., at 133.

[FN56]. Cf. Carnegie Trust Co. v. First National Bank, 213 N.Y. 301, 107 N.E. 693 (1915).

[FN57]. The plaintiff in the action in which the jus tertii defense is raised, but the defendant in respect to the claim.

[FN58]. See Note, Personal Money Orders and Tellers Checks: Mavericks under the U.C.C., 67 COLUM.L.REV. 524, 546 (hereinafter: Note-Money Orders); Note, Blocking Payment on a Certified, Cashier's or Bank Check, 73 MICH.L.REV. 424, 433 (1974) (hereinafter: Note-Blocking Payment), and especially footnote 60; Blum, supra note 13, at 131-32; Britton, supra note 1, at 462-69; Peters-Primer, supra note 34, at 56.

[FN59]. Chafee, supra note 48, at 1110.

[FN60]. "Bank money orders notes, the official instruments of the issuing bank, signed by an authorized agent thereof and issued to a named payee." Note-Money Orders, supra note 58, at 525.

[FN61]. U.C.C. § 3-104, Comment 4.

[FN62]. "A bill of exchange or draft drawn by a bank upon itself and is accepted by the act of issuance." See Fox, Stopping Payment on Cashier's Check, 19 B.C.L.REV. 683 (1977).

[FN63]. Teller's checks are drawn by savings banks and savings and loan associations on commercial banks with which they maintain checking accounts. Note-Money Orders, supra note 58, at 540.
The certified check does not create that problem: A certified check is a personal check drawn by a depositor on his account, and signed by an authorized bank officer. J. Brady, The Law of Bank Checks 148 (4th ed. 1969). Although the primary obligor is the bank (as acceptor), the customer is a party to the instrument, namely the drawer.
The postal money order does not cause those problems, since it is non- negotiable. See 39 U.S.C. § 5104 (1991); Note-Money Orders, supra note 58, at note 7.

[FN64]. At least not in the proper sense, although an opposite argument may be advanced when the underlying obligation is a sale or another U.C.C.-governed transaction, because the U.C.C. has a definition to the term "party" in § 1- 201 ("... a person who has engaged in a transaction or made an agreement within this act.") This definition is too broad, at least as to parties to negotiable instruments, should probably be replaced for the purposes of Article 3.

[FN65]. Blum, supra note 13, at 135.

[FN66]. Section 3-603 (even the section numbers mirror each other!) discharges the obligor upon payment, and protects the payor against future claims by another party who has a claim to the instrument. The exceptions to the discharge rule mirror the exceptions to the jus tertii rule, so that when a party may raise a jus tertii defense, under certain circumstances he has to do it, otherwise he risks having to pay a second time.

[FN67]. For example, one who pays the holder is not liable towards someone for whom the instrument was held in trust by the paid holder.

[FN68]. To the extent this is jus tertii, since the financial institution is really just in the shoes of its customer, representing him. It is not much more than a check of the customer, or at least something jointly produced by the customer and the bank.

[FN69]. See Note-Money Orders, supra note 58; Note-Blocking payment, supra note 58; Fox, supra note 61; Comment: Bossuyt v. Osage Farmers National Bank: Cashier's Checks Under the Iowa Uniform Commercial Code, 73 IOWA L.REV. 521 (1988); Wallach, Negotiable Instruments: The Bank Customer's Ability to Prevent Payment On Various Forms of Checks, 11 IND.L.REV. 579 (1978).

[FN70]. The exceptions are dealt with here only with respect to the legal situation under the U.C.C. The policy arguments as to their justification are discussed in the parts dealing with economics and policy.

[FN71]. Weber and Speidel, supra note 3, at 106 (although at p. 366 they take the opposite view, in what appears to be a slip of the pen); Chafee, supra note 48, at 1112; The question of the legal title is a separate one: Professor Chafee argues that a thief also has legal title (id.). Others have disagreed. See especially A. Barak, The Nature of the Negotiable Instrument 46-53 (1972).

[FN72]. See § 3-111 as to the ways an instrument is payable to bearer. The term "bearer" itself is defined in § 1-201:" ... means the person in possession of an instrument...."

[FN73]. Section 3-204(2): "An indorsement in blank specifies no particular indorsee, and may consist of a mere signature. And instrument payable to order and indorsed in blank becomes payable to bearer...."

[FN74]. He may, of course, negotiate it for value, and benefit from the consideration.

[FN75]. Blum, supra note 13, at 140.

[FN76]. See text accompanying infra notes 108-111.

[FN77]. Weber and Speidel, supra note 3, at 123.

[FN78]. Formerly § 39 of the N.I.L.

[FN79]. Formerly § 36 of the N.I.L.

[FN80]. See Official Comment 1 to § 3-205; Weber and Speidel, id., at 124; cf. Britton, supra note 1, at 153-58.

[FN81]. Section 3-205(b).

[FN82]. Section 3-206(1).

[FN83]. See generally Britton, supra note 1, at 151; Weber and Speidel, supra note 3, at 124-25. Like all the other restrictive indorsements, it does not prevent further negotiation. See U.C.C. § 3-206(1).

[FN84]. Namely, the indorser.

[FN85]. The Official Comment gives a cross reference to that section. Section 3-803 provides:

Notice to Third Party
Where a defendant is sued for the breach of an obligation for which a third person is answerable under this Article he may give the third person a written notice of the litigation, and the person notified may then give similar notice....

[FN86]. Official Comment to § 3-803.

[FN87]. Although they are not so easy to use: See Note-Blocking Payment, supra note 58, at 432-37.

[FN88]. It was recognized, although narrowly, by the Common Law. See Note Blocking payment, id. There was even some authority that the third party does not have to formally join the proceedings, and it may be enough that they are all standing before the court. See Fulton National Bank v. Delco Corp., 128 Ga.App. 16, 195 S.E.2d 455; jus tertii under the Common Law, supra note 16.

[FN89]. Blum, supra note 13, at 138.

[FN90]. R. Posner, Economic Analysis of Law (3d ed. 1986) has two sentences on the doctrine of the holder in due course. This is two sentences more than, e.g., A. Polinsky, An Introduction to Law and Economics (1983); R. Cooter and T. Ulen, Law and Economics (1988) (hereinafter Cooter and Ulen).

[FN91]. "Since the enactment of the English Bills of Exchange Act in 1882, the courts--and following in their footsteps a majority of legal scholars--in the Common Law countries have ceased to give any thought to the theoretical nature of the negotiable instrument.... This is regrettable, because theory is very often a matter of great practical importance." Barak-Nature, supra note 49, at 49-50.

[FN92]. See text accompanying supra notes 49-50.

[FN93]. Mautner, Letters-Of-Credit Fraud: Total Failure of Consideration, Substantial Performance and the Negotiable Instruments Analogy, 18 LAW & POL'Y INT'L BUS. 579, 641.

[FN94]. See, e.g., 12 Encyclopaedia Britannica, Macropedia 350-51 (15th ed. 1974); 10 International Encyclopedia of the Social Sciences 426-27 (1968).

[FN95]. Most checks, except for post-dated checks (where allowed) are of that kind.

[FN96]. Collection may take up to six weeks, in the case of out-of-the country checks, and even longer periods when the obligor refuses to pay and the holder must go through legal and effectuation proceedings. In instruments that are also an extension of credit, namely they require payment on a future definite time--see U.C.C. § 3-109--the time measured should be from the definite time until collection. However, the value of that second part may be compensated for in legal proceedings.

[FN97]. Other risks, like the risk of loss or theft (see U.C.C. § 3-804) exist too; however, they also exist in respect to money.

[FN98]. The same analysis applies probably to credit cards, with slight differences: a higher commission, a fixed delay in payments, but--subject to approval by the credit card company before the transaction is effectuated--it guarantees certainty of the payment (to be precise--with the exception of when the credit card company becomes insolvent meanwhile) plus the attraction of customers because of convenient methods of payment.

[FN99]. A Schwartz and R. Scott, Commercial Transactions, Principles and Policies 870 (1972).

[FN100]. See Cowen, supra note 5, at 9-14 for this and three other approaches. The most notable users of this approach are Lewellyn, Meet Negotiable Instrument, 44 COLUM.L.REV. 299 (1944) and W. Hawkland, Commercial Paper (2d ed. 1979).

[FN101]. Some commentators argue that at least with respect to checks, the rule that favors negotiability over other concerns should be changed. See Rosenthal, Negotiability--Who Needs It?, 71 COLUM.L.REV. 375, 382 (1977). Though convincing, this view did not change the law yet.

[FN102]. See, in respect to contracts law, Polinsky, supra note 89, at 25.

[FN103]. Even between immediate parties, whose relationships are mainly governed by contracts law, the application of the efficient gap filling theory is sabotaged by the fact that in order to be really negotiable, namely a money equivalent, as few reservations and restrictions as possible should appear on that instrument itself. Thus, again, the possibility of the parties to shape the contract as they wish is limited, otherwise they bear the risk that a prospective indorsee will refuse to take it.

[FN104]. See Britton, supra note 1, at 201-09. See also, in respect to chattels, text accompanying infra notes 125-127 and infra note 130.

[FN105]. See text accompanying supra notes 84-87.

[FN106]. When the third party intervenes, it would usually mean that there would have been a chain of actions, since he shows interest in claiming his rights. Thus the intervening third party exception is always efficient.

[FN107]. Cf. text accompanying supra notes 82-84.

[FN108]. This windfall might be only temporary, since B may get the money from whoever gets it at this stage. However, the temporary windfall would turn permanent if B does not bring legal action.

[FN109]. The only possible exception to this is when the obligor is a consumer, a category that the law tends to favor. However, when the consumer has no concerns of his own, which is the case in the jus tertii area, there is no reason to "protect" him by giving him windfalls. Moreover, the consumer is protected by a variety of other means, such as forbidding the use of negotiable instruments in consumer installment transactions. See Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 YALE L.J. 1057, 1097-1100 (1954); Schwartz, Optimality and the Cut Off of Defenses Against Financiers of Consumer Sales, 15 B.C.IND. AND COMM.L.REV. 499, 500 (1974); Benfield, The New Payments Code and the Abolition of the Holder in Due Course Status as to Consumer Checks, 40 WASH. & LEE L.REV. 11 (1983). Some concern may arise in respect to special negotiable instruments, in which the bank raises its customer's defense after a "stop payment" order by the customer, a consumer. However, almost invariably under these circumstances it should be possible for the customer to join the litigation, and the third party

intervening exception would apply. It is unclear whether the existing law is sufficient to facilitate the customer to join the action since he is not a party to the instrument and not liable on it. See U.C.C. § 3-803. The law should be clarified and unconditionally allow the consumer to join the action. Under such a rule, the consumer does not need further protection as a maker of a note.

[FN110]. A jus tertii situation may arise in the claim of a plaintiff holder in due course. Assume that in the basic example, B is a minor, entitled to the infancy defense, but C does not know that and has no reason to suspect it, so that he acts in good faith. C may fulfill all the requirements to achieve the status of a holder in due course (see footnote 40, supra), but B may have a claim to the instrument. C, however, even though being a holder in due course, cannot sue B as a secondary obligor. See § 3-305(2)(a).

[FN111]. See supra note 70 and accompanying text.

[FN112]. See U.C.C. § 3-303 and footnote 41 supra.

[FN113]. See footnote 109 supra.

[FN114]. Using the example set forth in footnote 109: the holder, C, gave the payee, B, value for his indorsement. If B, using his infancy, sues C for restitution of the instrument, B would probably have to return to C the value paid for the indorsement, and B ends up where he was before the transaction. But if for some reason B does not sue, for example because the value given was adequate, then allowing A to raise B's infancy defense would leave A with the windfall, and C without the value he paid, without the instrument's proceeds, and with no recourse against B (§ 3-305(2)(a)).

[FN115]. See text accompanying supra notes 42-46.

[FN116]. The exception that the third party himself defends the action is not relevant here, because it has already been argued that whenever such an exception occurs, it is efficient to allow the use of jus tertii defenses. See text accompanying supra notes 104-06. The exception that the holder acquired the instrument (himself) by theft is also not relevant, because he cannot have the standing of the bona fide purchaser. He cannot at the same time be a thief and act in good faith. See the definition of good faith, § 1-201(19).

[FN117]. This might occur, for example, because the instrument is overdue. See § 3-304(3).

[FN118]. This is the result under the Code. It is sometimes justified by the idea that by creating an incentive for each buyer to check the immediate party from whom he acquires the instrument, theft would be avoided because people will take care to avoid purchasing an instrument from a thief. This argument seems neither factually accurate, nor has such an importance as to justify interference with the negotiability concept by requiring an investigation of the person from whom the instrument is acquired. The commercial environment, in many cases does not supply an adequate chance for such an investigation. Also, in today's society, the risks of using negotiable instruments made a lot of people decide that they would not accept them as a method of payment. Increasing the risk in that way may bring many more people to the position that because of all the risks involved, they should not accept negotiable instruments for payment.

[FN119]. Text accompanying notes 77-81 supra.

[FN120]. Official Comment 3 to U.C.C. § 3-603.

[FN121]. This does not mean that "restrictive indorsement" has no remaining legal meaning. It would continue to have full effect on the relationship between the immediate parties, i.e., the indorser and the indorsee.

[FN122]. Section 3-603.

[FN123]. The Israeli Negotiable Instrument Ordinance leaves the obligor with the option of raising a defense based on the restrictive indorsement, or paying the plaintiff and being discharged.

[FN124]. Cf. the "fraud exception" in letter-of-credit law. Mautner, supra note 92.

[FN125]. Chafee, supra note 48, at 1112.

[FN126]. Britton, supra note 1, at 473.

[FN127]. Blum, supra note 13, at 141.
Britton was well aware of the weaknesses of his argument, and expressed it better than anyone: "At first thought it does make one a bit 'sqeamish' to classify criminals and to say to the sticky fingered contingent: 'You are so bad that you cannot get into the court house to sue on your stolen instrument' but to say to the oily tongue confidence man and false pretender: 'We do not like you much better than we do the thief. Indeed, we intend to send both of you to jail, but in as much as you used more refined tools in separating the owner from his property by giving him a sporting chance to refuse to deal with you, we will let you sue on your criminally obtained instrument and to recover thereon, provided that your victim is not a party to the action'." Id., at 472-73.

[FN128]. B. Cardozo, The Nature of the Judicial Process 4 (1921) (in a different context).

[FN129]. Id.

[FN130]. "After all, if he can successfully refuse to pay this person, perhaps the true owner will never come around, or if he does, he may have difficulty recovering on the instrument because he does not have possession of it." Hart and Willier, supra note 25, at § 12.31(2).

[FN131]. In other legal systems a bona fide purchaser for value of an asset--gets, under certain conditions, clear title. See, e.g., the Market Overt in England, that was not accepted in the U.S. Warren, Cutting Off Claims of Ownership Under the Uniform Commercial Code, 30 U.CHIC.L.REV. 469 (1963); § 34 of the Israeli Sales Act, 1968. For an economic analysis of the different entitlements, see Cooter and Ulen, supra note 89 at 152.

[FN132]. "At least where the third person who receives the stolen funds does so in good faith and for a valuable consideration" 54 AM.JUR.2d Money § 7 (1971).

[FN133]. U.C.C. § 3-201(1).

[FN134]. Appropriate adjustment is required in the discharge section, § 3-603.
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