25.5: Discharge

Learning Objective

1. Understand how the obligations represented by commercial paper may be discharged.

Overview

Negotiable instruments eventually die. The obligations they represent are discharged (terminated) in two general ways: (1) according to the rules stated in Section 3-601 of the Uniform Commercial Code (UCC) or (2) by an act or agreement that would discharge an obligation to pay money under a simple contract (e.g., declaring bankruptcy).

Discharge under the Uniform Commercial Code

The UCC provides a number of ways by which an obligor on an instrument is discharged from liability, but notwithstanding these several ways, under Section 3-601, no discharge of any party provided by the rules presented in this section operates against a subsequent holder in due course unless she has notice when she takes the instrument.

Discharge in General

Discharge by Payment

A person primarily liable discharges her liability on an instrument to the extent of payment by paying or otherwise...
satisfying the holder, and the discharge is good even if the payor knows that another has claim to the instrument. However, discharge does not operate if the payment is made in bad faith to one who unlawfully obtained the instrument (and UCC Section 3-602(b) lists two other exceptions).

Discharge by Tender

A person who tenders full payment to a holder on or after the date due discharges any subsequent liability to pay interest, costs, and attorneys’ fees (but not liability for the face amount of the instrument). If the holder refuses to accept the tender, any party who would have had a right of recourse against the party making the tender is discharged. Mario makes a note payable to Carol, who indorses it to Ed. On the date the payment is due, Mario (the maker) tenders payment to Ed, who refuses to accept the payment; he would rather collect from Carol. Carol is discharged: had she been forced to pay as indorser in the event of Mario’s refusal, she could have looked to him for recourse. Since Mario did tender, Ed can no longer look to Carol for payment. Uniform Commercial Code, Section 3-603(b).

Discharge by Cancellation and Renunciation

The holder may discharge any party, even without consideration, by marking the face of the instrument or the indorsement in an unequivocal way, as, for example, by intentionally canceling the instrument or the signature by destruction or mutilation or by striking out the party’s signature. The holder may also renounce his rights by delivering a signed writing to that effect or by surrendering the instrument itself. Uniform Commercial Code, Section 3-604.

Discharge by Material and Fraudulent Alteration

Under UCC Section 3-407, if a holder materially and fraudulently alters an instrument, any party whose contract is affected by the change is discharged. A payor bank or drawee paying a fraudulently altered instrument or a person taking it for value, in good faith, and without notice of the alteration, may enforce rights with respect to the instrument according to its original terms or, if the incomplete instrument was altered by unauthorized completion, according to its terms as completed.

- Example 1: Marcus makes a note for $100 payable to Pauline. Pauline fraudulently raises the amount to $1,000 without Marcus’s negligence and negotiates it to Ned, who qualifies as a holder in due course (HDC). Marcus owes Ned $100.
- Example 2: Charlene writes a check payable to Lumber Yard and gives it to Contractor to buy material for a deck replacement. Contractor fills it in for $1,200: $1,000 for the decking and $200 for his own unauthorized purposes. Lumber Yard, if innocent of any wrongdoing, could enforce the check for $1,200, and Charlene must go after Contractor for the $200.

Discharge by Certification

As we have noted, where a drawee certifies a draft for a holder, the drawer and all prior indorsers are discharged.


Updated: Tue, 22 Feb 2022 02:02:37 GMT
Powered by
Discharge by Acceptance Varying a Draft

If the holder assents to an acceptance varying the terms of a draft, the obligation of the drawer and any indorsers who do not expressly assent to the acceptance is discharged. Uniform Commercial Code, Section 3-410.

Discharge of Indorsers and Accommodation Parties

The liability of indorsers and accommodation parties is discharged under the following three circumstances. Uniform Commercial Code, Section 3-605.

Extension of Due Date

If the holder agrees to an extension of the due date of the obligation of the obligor, the extension discharges an indorser or accommodation party having a right of recourse against the obligor to the extent the indorser or accommodation party proves that the extension caused her loss with respect to the right of recourse.

Material Modification of Obligation

If the holder agrees to a material modification of the obligor’s obligation, other than an extension of the due date, the modification discharges the obligation of an indorser or accommodation party having a right of recourse against the obligor to the extent the modification causes her loss with respect to the right of recourse.

Impairment of Collateral

If the obligor’s duty to pay is secured by an interest in collateral and the holder impairs the value of the interest in collateral, the obligation of an indorser or accommodation party having a right of recourse against the obligor is discharged to the extent of the impairment.

The following explanatory paragraph from UCC Section 3-605, Official Comment 1, may be helpful:

Bank lends $10,000 to Borrower who signs a note under which she (in suretyship law, the “Principal Debtor”) agrees to pay Bank on a date stated. But Bank insists that an accommodation party also become liable to pay the note (by signing it as a co-maker or by indorsing the note). In suretyship law, the accommodation party is a “Surety.” Then Bank agrees to a modification of the rights and obligations between it and Principal Debtor, such as agreeing that she may pay the note at some date after the due date, or that she may discharge her $10,000 obligation to pay the note by paying Bank $3,000, or the Bank releases collateral she gave it to secure the note. Surety is discharged if changes like this are made by Bank (the creditor) without Surety’s consent to the extent Surety suffers loss as a result. Section 3-605 is concerned with this kind of problem with Principal Debtor and Surety. But it has a wider scope: it also applies to indorsers who are not accommodation parties. Unless an indorser signs without recourse, the indorser’s liability under section 3-415(a) is that of a surety. If Bank in our hypothetical case indorsed the note and transferred it to Second Bank, Bank has rights given to an indorser under section 3-605 if it is Second Bank that modifies rights and obligations of Borrower.
Discharge by Reacquisition

Suppose a prior party reacquires the instrument. He may—but does not automatically—cancel any indorsement unnecessary to his title and may also reissue or further negotiate the instrument. Any intervening party is thereby discharged from liability to the reacquiring party or to any subsequent holder not in due course. If an intervening party’s indorsement is cancelled, she is not liable even to an HDC. Uniform Commercial Code, Section 3-207.

Discharge by Unexcused Delay in Presentment or Notice of Dishonor

If notice of dishonor is not excused under UCC Section 3-504, failure to give it discharges drawers and indorsers.

Key Takeaway

The potential liabilities arising from commercial paper are discharged in several ways. Anything that would discharge a debt under common contract law will do so. More specifically as to commercial paper, of course, payment discharges the obligation. Other methods include tender of payment, cancellation or renunciation, material and fraudulent alteration, certification, acceptance varying a draft, reacquisition, and—in some cases—unexcused delay in giving notice of presentment or dishonor. Indorsers and accommodation parties’ liability may be discharged by the same means that a surety’s liability is discharged, to the extent that alterations in the agreement between the creditor and the holder would be defenses to a surety because right of recourse is impaired to the surety.

Exercises

1. What is the most common way that obligations represented by commercial paper are discharged?
2. Parents loan Daughter $6,000 to attend college, and she gives them a promissory note in return. At her graduation party, Parents ceremoniously tear up the note. Is Daughter’s obligation terminated?
3. Juan signs Roberta’s note to Creditor as an accommodation party, agreeing to serve in that capacity for two years. At the end of that term, Roberta has not paid Creditor, who—without Juan’s knowledge—gives Roberta an extra six months to pay. She fails to do so. Does Creditor still have recourse against Juan?