

Getting Attached

When do allonges meet the requirements of the New York UCC?

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WHenever a lender transfers or pledges a loan, counsel will remember from law school that the assignor must “indorse”¹ the promissory note to the assignee. Traditionally, indorsements appeared on the same piece of paper as the note. In today’s practice, though, an indorsement often appears on a separate page, an “allonge,” thrown into a folder with the promissory note but not physically attached to it. At best, someone might attach the allonge to the note with a paper clip.

Though prevalent, these practices do not meet the technical requirements of the New York Uniform Commercial Code to make the transferee of a promissory note its “holder.” The potential result: unnecessary and totally avoidable legal issues if the purchaser or pledgee ever needs to establish it holds the note. For example, in a foreclosure, these imperfections might let the borrower defeat a motion for summary judgment by claiming the plaintiff doesn’t validly hold the loan.

The problem arises from a careful reading of the technical requirements of the UCC as in effect in New York (New York UCC).² New York is one of only two states that still use the antiquated 1951 version of UCC Article 3.³

The ‘No-Space Test’

Under any UCC, if a transferee (whether buyer or secured party) wants to become a “holder”⁴ of a negotiable instrument⁵—or, better, a “holder in due course”⁶—the transferor must first duly

“negotiate” the instrument to the new holder. Negotiation of a negotiable⁷ instrument requires delivery of the instrument to the holder with any necessary indorsement.⁸ Being a holder (even “in due course”) of an instrument is not necessarily the same as owning it, though some courts do not grasp the distinction.⁹

An indorsement on the front or back of an instrument will unquestionably meet the test for “negotiation.” A separate piece of paper—today’s industry standard, the “allonge”—raises legal issues that impair its effectiveness as a valid indorsement.

First, ancient principles of commercial law, possibly still good law in New York, prohibit use of any additional piece of paper for an indorsement as long as enough space remains to write the indorsement somewhere on the instrument itself (the “No-Space Test”).

Second, even when the law allows a separate indorsement, the New York UCC literally requires an allonge to be “firmly affixed” to the instrument, a requirement that today’s practice generally flunks.

Historically, the law disfavored use of an allonge to indorse an instrument. The majority view under all of the “law merchant,”¹⁰ the Uniform Negotiable Instruments Law (NIL),¹¹ and the common law applied the No-Space Test.¹²

An overwhelming majority of courts in other states that have expressly considered this issue have repeatedly interpreted the 1951 version of UCC §3-202 to carry forward the No-Space Test.¹³ On the other hand, quite a few cases have allowed a separate allonge under these circumstances.¹⁴ Only a few of these cases expressly considered whether a particular instrument still had room for an indorsement.¹⁵ These cases generally upheld an allonge without discussing the No-Space Test.

No New York case expressly decides whether the New York UCC includes a No-Space Test. A few New York cases on allonges,¹⁶ and a few from out of state applying the 1951 UCC, do

not consider whether the instrument still had enough space for an indorsement.

The Official Text of Revised Article 3 does not directly address a No-Space Test. But Official Comment 1 to Revised Section 3-204 says: “An indorsement on an allonge is valid even though there is sufficient space on the instrument for an indorsement.”

If New York enacted the Revised UCC, any concern about a No-Space Test would diminish to the vanishing point. But New York, along with only South Carolina, hasn’t done that. Accordingly, the No-Space Test remains at least a lingering concern in New York. And if lenders want to identify and mitigate every possible legal risk in their documents—as they do—they should assume, conservatively, that New York has a No-Space Test.¹⁷

If New York law does not have a No-Space Test, or if a particular transaction has satisfied the test, counsel must then ask two more questions before using an allonge. Must the parties physically attach the allonge to the instrument being indorsed? If so, what does “physical attachment” require?

Physical Attachment

New York UCC §3-202(2) states: “An indorsement must be written by or on behalf of the holder and on the instrument or on a paper so firmly affixed thereto as to become a part thereof.” This requirement tightened the NIL’s previous requirement that the indorsement “be written on the instrument itself or upon a paper attached thereto.”

The change was deliberate, apparently designed to assure the indorsement would travel with the instrument. This, it was thought, would “protect subsequent purchasers from the risk that the present holder or a previous holder has negotiated the instrument to someone outside the apparent chain of title through a separate document.”¹⁸

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Courts disagree on how an allonge must be physically attached to an instrument. Numerous cases have rejected indorsements on separate sheets of paper loosely inserted in a folder with the instrument, not physically attached in any way.¹⁹ Therefore, today's common practice—including the allonge in the closing set without attaching it to the note—simply asks for trouble. An official comment to the New York UCC expressly rejects use of a paper clip, probably the technique most commonly used when people bother to attach the allonge at all.²⁰

A staple seems to suffice as an attachment technique. Although the official comments to the UCC neither approve nor reject staples, a draft of the 1951 version of UCC Article 3 did include this comment: "The indorsement must be written on the instrument itself or an allonge, which, as defined in Section _____, is a strip of paper so firmly pasted, stapled or otherwise affixed to the instrument as to become part of it."²¹

Consistent with this view, the Colorado Supreme Court concluded that a stapled allonge was "firmly affixed" so as to "become a part" of the instrument, as UCC §3-202(2) requires of an allonge. In the court's words: "stapling is the modern equivalent of gluing or pasting."²² The Texas Supreme Court agrees.²³

Commentators cite many cases for the proposition that staples will not suffice. A closer examination reveals, though, that each such case was decided on other grounds. For example, in *Tallahassee Bank & Trust Co. v. Raines*,²⁴ a Georgia appellate court rejected the use of a stapled allonge, but did so based on the No-Space Test.²⁵ Although an allonge happens to have been stapled in this and many similar cases, the outcome depended on failure to satisfy the No-Space Test, not the method of attachment.

*Crossland Sav. Bank FSB v. Constant*²⁶ is also often cited for a "no staples" rule. There, though, the indorsements were not stapled to the instruments themselves, but instead to the back of another document in a group of documents that included the notes.

Taking into account the UCC and the case law, a loan purchaser can probably satisfy the "firmly affixed" requirement by stapling an allonge to an instrument. Neither glue, nor sealing wax, nor red ribbon seems necessary. Therefore, if a loan purchaser has satisfied, or decided not to worry about, the No-Space Test, the loan purchaser should bring a stapler to the closing, and staple each allonge to the note being indorsed.

But why bother? Couldn't the loan purchaser throw the unstapled allonge in the closing file and then staple it to the note later, if the purchaser ever needs to prove it is a "holder"? Though this approach seems practical and reasonable, it hardly conforms to the level of perfection, care, and risk mitigation typical in commercial real estate financing.

In all likelihood, if and when the loan purchaser needs to enforce the note, no one will think of stapling the allonge (if it can still be found) to the note. Even if someone finds the allonge and remembers, the practice might give the borrower a factual issue and hence a possible defense. A loan purchaser should "do it right" and staple the allonge at closing.

More generally, loan originators may wish to revert to the earlier practice of preprinting an endorsement in blank after the signature block of every promissory note, to simplify future indorsements and prevent mistakes.

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1. Both the New York UCC and Revised Article 3, as defined below, say "indorse" rather than "endorse." So will this article.

2. This article considers only the New York UCC (1951 version) unless otherwise stated.

3. The other is South Carolina. All other jurisdictions have enacted the 1990 version (Revised Article 3). Some have even adopted the 2002 amendments. Revised Article 3 eliminates most concerns this article raises.

4. New York UCC §1-201(20) defines "holder" as someone who possesses an instrument "drawn, issued or indorsed to him or his order or to bearer or in blank." By becoming a holder, an assignee may enforce payment, shifting the burden to the maker to establish any defense, and prevents the maker from discharging the note by paying a previous holder. See New York UCC §§3-301, 307(2), and 603(1).

5. See New York UCC §3-104 (requirements for a writing to constitute a negotiable instrument).

6. A "holder in due course" has better rights than a mere "holder," taking free of anyone else's claims to the note and many defenses the maker might otherwise assert. New York UCC §3-305. A holder in due course may still face a few defenses, not relevant here. Conversely, if a loan purchaser doesn't become a "holder" at all, the purchaser may encounter serious difficulties in enforcing the loan.

7. New York UCC §3-102(1)(e) defines "instrument" as a negotiable instrument. See also Revised UCC §3-102(a) ("This Article applies to negotiable instruments."). Courts often treat UCC Article 3 as a codification of the common law, applying it to all notes without regard to negotiability.

8. New York UCC §3-202(1). Instruments payable to bearer do not need indorsements, just delivery. *Id.*

9. *LaSalle Nat'l Bank Ass'n v. Lamy*, 12 Misc. 3d 1191A (2006), illustrates the distinction. There, the assignee took an assignment of the note without at the same time receiving an indorsement from the proper party. The assignee later did receive an allonge from the proper party, but did not attach it to the note. The court correctly held that this allonge was not an "indorsement" under New York UCC §3-202(2). Hence, the court decided, the assignor still owned the note and the assignee could not obtain a default judgment on the note. This and similar cases, see, e.g., *Slutsky v. Blooming Grove Inn, Inc.*, 542 N.Y.S.2d 721 (1989), improperly ignore the "shelter" principle of New York UCC §3-201(1). That principle states that any transferee of an instrument—even if not a "holder"—generally receives whatever rights the transferor had in the instrument (assuming no illegality, fraud, or other wrongful conduct by the transferee). A transferee that is not a holder can still be the owner of a note and entitled to enforce it, but cannot claim the same presumption of ownership as a "holder," and may need to persuade a court of its rights. See New York UCC §3-201, Official Comment 8. See also *Goshen National Bank v.*

Bingham, 118 N.Y. 349, 355 (1890) ("When...an instrument is transferred, but without indorsement...[t]he assignee acquires all the title of the assignor, and may maintain an action thereon in his own name....").

10. The law merchant has been described as "a system of law that does not rest exclusively on the institutions and local customs of any particular country, but consists of certain principles of equity and usages of trade which general convenience and a common sense of justice have established to regulate the dealing of merchants and mariners in all the commercial countries of the civilized world." *Bank of Conway v. Stary*, 51 N.D. 399 (1924).

11. The National Conference of Commissioners on Uniform State Laws promulgated NIL in 1896. By 1924, every state had enacted it. See 2 F. Hart & W. Willier, *Commercial Paper under the Uniform Commercial Code* §1.06, at 1-25 to -26 (1988). UCC Article 3 superseded NIL.

12. See generally Annot., *Indorsement of Negotiable Instruments by Writing Not on Instrument Itself*, 19 A.L.R.3d 1297, 1301-1304 (1968) and Annot., *Indorsement of Bill or Note by Writing Not on Instrument Itself*, 56 A.L.R. 921, 924-926 (1928). A few states limited allonges by statute. For example, California Civil Code §3109, adopted in 1872, declared until California adopted NIL: "One who agrees to indorse a negotiable instrument is bound to write his signature upon the back of the instrument, if there is sufficient space thereon for that purpose." The *Pribus* case cited in the next footnote concluded, though, that California's No-Space Test survived both NIL and the 1951 version of UCC Article 3.

13. *Pribus v. Bush*, 118 Cal.App.3d 1003 (1981); *Shepherd Mall St. Bank v. Johnson*, 603 P.2d 1115, 1118 (Okla. 1979); *Tallahassee Bank & Trust Company v. Raines*, 187 S.E.2d 320, 321 (Ga. App. 1972); *James Talcott, Inc. v. Fred Ratovsky Assoc., Inc.*, 38 Pa. D. & C.2d 624, 2 U.C.C. Rep. Serv. 1134, 1137 (1965).

14. The annotations cited in footnote 13 identify many such cases.

15. *Crosby v. Roub*, 16 Wis. 616 (1863); *Commercial Secur. Co. v. Main St. Pharmacy*, 174 N.C. 655 (1917).

16. *Cadle v. Nickelson*, 1996 U.S. Dist. LEXIS 18655 (1996); *LaSalle Bank Nat'l Ass'n v. Lamy*, 12 Misc. 3d 1191A (2006); *Philip Irwin Aaron, P.C. v. Matikow*, 2002 U.S. Dist. LEXIS 26281. In contrast, an ancient New York case addressed allonges in considering a guarantee that looked like an allonge. The assignee argued that the guarantee was just like an indorsement, hence should travel with the note. The appellate court (the former Supreme Court of Judicature) reversed the lower court and held that the guarantee did not run with the note. In dicta, the appellate court quoted approvingly this language on indorsements from a then-current treatise: "If there be not room on the bill, others may be added on an annexed paper called *an allonge*." *Watson's Executors v. McLaren*, 19 Wend. 557; 1838 N.Y. LEXIS 154 (1838), citing *Chit., Bills, Am. Ed. Of 1836 at 326*. (Italics added.)

17. NIL §31. Revised Article 3—not the law in New York—has returned to a standard like the old NIL, stating: "a paper affixed to the instrument is a part of the instrument." Revised UCC §3-204.

18. *Adams v. Madison Realty & Dev., Inc.*, 853 F.2d 163 at 165 (3d Cir. 1988).

19. *Id.*; *Big Builders, Inc. v. Israel*, 709 A.2d 74 (D.C. 1988); *Town of Freeport v. Ring*, 1999 Me. 48.

20. "Subsection (2) follows decisions holding that a purported indorsement on a mortgage or other separate paper pinned or clipped to an instrument is not sufficient for negotiation." New York UCC §3-202, Official Comment 2.

21. ALI, *Comments & Notes to Tentative Draft No. 1—Article III 114* (1946), reprinted in 2 Elizabeth Slusser Kelly, *Uniform Commercial Code Drafts* 311, 424 (1984).

22. *Lamson v. Commercial Cred. Corp.*, 187 Colo. 382 (1975). Stapling hardly achieves the goal of preventing a noteholder from fraudulently "hiding" an indorsement of a note still in his possession, as he could presumably find a staple remover. A couple of vestigial staple holes would hardly place a third party on notice of the fraudulently hidden indorsement.

23. *Southwestern Resolution Corp. v. Watson*, 964 S.W.2d 262 (1997). Though the case applied the stricter 1951 UCC, Texas' enactment of Revised Article 3 with its looser "affixed" requirement may have influenced the result.

24. 187 S.E.2d 320, 321 (Ga. App. 1972).

25. *Pribus v. Bush*, 118 Cal.App. 3d 1003 (1981), is also often cited for the "no staples" rule, but it too turned on the No-Space Test.

26. 737 S.W.2d 19, 21 (Tex. Ct. of App. 1987) ("We cannot say the [trial] court abused its discretion in finding that no valid allonge existed where, as here, the purported indorsements were not attached next to the notes themselves but were stapled to the back of another document in a group of documents which included the notes."). The court's decision seemed to be a generally unfavorable view of allonges based on the No-Space Test. *Id.* at 21.