TOPIC 20: COMMERCIAL PAPER

Overview

Commercial paper is a document that promises to pay a sum of money to the holder or possessor of the instrument. It is very common to use commercial paper as consideration in a business transactions rather than cash. This chapter introduces commercial paper. It identifies the main types and requirements (elements) of commercial paper. It explains the rights of a holder or possessor of the commercial paper and the obligations of the payor of the instrument. It also provides for the rights of subsequent transferees or purchasers of the commercial paper. Notably, it introduces the concept of a holder in due course. Lastly, it provides for the potential liability of any maker, drawer, transferor, signor, or individual presenting the commercial paper for payment.

VIDEO LESSON - INTRODUCTION

VOCABULARY & CONCEPTS

TOPIC 20: COMMERCIAL PAPER - QUESTIONS & ANSWERS

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1. What is "Commercial Paper"?

Commercial paper is a broad categorization of financial instruments (also referred to as an "instrument") promising to pay or ordering payment to a person legally entitled to enforce the instrument. Because it has value for the individual in possession or holding the instrument, it is used as a substitute to money in commercial transactions.

- *Example*: A check is commercial paper that orders a third party to pay money. A promissory note is another form of commercial paper that evidences a loan and outlines the duty of the maker of the note to make payment to the holder of the note.

- ***Discussion***: Why do you think it is necessary for commercial paper to entail an "unconditional" right to be paid? How is commercial paper different from a contract?

2. What are common types of commercial paper?

When examining the attributes of commercial paper, it is important to differentiate between the most common types of instrument. The types of commercial instrument include:

- *Notes* - This is a promise to pay money. It involves two parties. The maker of the note makes an unconditional promise to pay the payee. The payee is the personal entitled to payment of the note. This is normally the holder of the notes. The payment may be due at a date certain or on payable on demand.
    - *Note*: Most notes, such as a promissory note, have some form of the word note in the name. Bank notes are called certificates of deposit (CD). The UCC generally lists CDs as a completely separate type of instrument from a note because they are the subject of numerous special rules.
    - *Example*: Amy creates a document in which she promises to pay the holder of the note $500. She gives the note to Brenda as payment for a contract to purchase goods. Brenda is now the holder of this note (commercial paper). Because no dates is stated on the note, it is payable on demand. That is, Brenda or some other holder can present the note to Amy at any time and ask for payment. If the note states that it will be paid on October 1, 2017, it is payable on time or at this stated date.
- *Drafts* - This is an order directing someone else to pay money. It involves three parties. The "drawer" is the maker of the draft. The "drawee" is the party ordered to make payment to the "payee" or holder of the draft. A draft can involve a drawee who is an individual or business.
    - *Note*: A check is the most common form of draft. In the case of a check, the drawee is a bank. The UCC generally lists a check as a completely separate type of instrument from a draft because checks are the subject of numerous special rules. Nonetheless, a check functions similarly to any form of draft.
    - *Example*: Charlie owes Doug money. Doug creates a document indicating that Charlie is ordered to pay

the owed money to Evan. The document (a draft) states that Evan can present the draft to Charlie at any time for payment. This is a draft payable on demand.

Either of these types of types of instrument can be a negotiable instrument if they meet specific requirements.

- ***Discussion***: Why do you think notes and drafts are categorized separately in the context of commercial paper? Can you think of situations where a note might meet the requirements of commercial paper but the draft would not? Vice Versa?
- ***Practice Question***: Phillip enters into a contract with Henry to sell him construction supplies. Henry asks Phillip if he is willing to accept commercial paper as payment instead of cash. Can you explain to Phillip what is commercial paper and the requirements for each type?
- ***Resource Video***: http://thebusinessprofessor.com/types-of-commercial-paper/

3. Who is a "holder" of commercial paper?

A holder is one who has possession of and is entitled to enforce the instrument. So, a person who is named as payee and possesses an instrument is a holder. If the commercial paper is not payable to a particular person (i.e., it is payable to anyone in possession of the paper), anyone who has possession is a holder. An individual who is issued a note or draft is a holder. A person can also become a holder by receiving the draft through "negotiation" of the instrument. Negotiation is discussed separately.

- *Note*: There are certain exceptions for this rule when the instrument is forged (i.e., the signature of the payor or payee is not genuine). A forged signature does not make the instrument payable to the forger or validly make the instrument bearer paper. A thief or finder of bearer paper, however, is a holder.
- *Example*: Harriet writes a check to John. John is a holder of this draft. If he indorses the check and transfers it to Kyle, Kyle is the new holder. If, however, Kyle had stolen the check from John and forged John's signature, Kyle is not a legal holder of the paper, as he is not legally entitled to enforce the instrument.

- ***Discussion***: Why do you think the definition of a holder excludes certain individuals who do not gain possession of the paper through a legal method?
- ***Practice Question***: Gary writes a check to Hannah. Irene steals the check from Hannah's mailbox and endorses the check to herself. Is Hannah a holder of the draft? Why?
- ***Resource Video***: http://thebusinessprofessor.com/who-is-a-holder-of-a-negotiable-instrument/

NEGOTIABILITY

Negotiability is a core concept in the transfer or sale of an instrument.

4. What is "negotiability" and why is it important?

Negotiation is the transfer of negotiable paper from one holder to another. To be a substitute for money, commercial paper must be freely transferable in the marketplace. That is, the paper must be "negotiable". Negotiability concerns the rights of the holder of commercial paper. Paper that is not negotiable may still be transferred; however, it is far less valuable than negotiable paper. This is because the holder has fewer rights in enforcing payment of the non-negotiable, commercial paper. The rights of a holder of each type of paper is as follows:

- *Non-negotiable Commercial Paper* - An individual in possession of a non-negotiable instrument stands in the shoes of the original issuee. That is, she has the exact same rights in the instrument as the original issuee held. This means that, if the original party loses his right to be paid (think of defenses to payment of a contract), so does the transferee of the commercial paper. As such, the value of non-negotiable instrument is far less valuable to a subsequent transferee who cannot be certain that she will receive payment without being subject to a payor defense.
    - *Example*: Sarah enters into a contract to sell equipment to Robert. Robert gives Sarah a non-negotiable promissory note to pay for the goods. So, Sarah is the holder of a promissory note that is non-negotiable. She transfers the note to Tim, who is now the holder. If Robert has a defense against his obligation to pay Sarah for the equipment (e.g., the equipment is faulty), he could assert that defense against his obligation to pay Tim if he presents the promissory note for payment. This possibility makes the note far less valuable to Tim.
- *Negotiable Commercial Paper* - The holder of negotiable paper may have greater rights than the original issuee. That is, when paper is negotiable and validly negotiated to a subsequent holder who qualifies as a "holder in due course", the holder may acquire greater rights to enforce the instrument against the payor or maker. The holder in due course will have a greater right to payment because the maker or payor cannot assert certain defenses (personal defenses) to payment against the holder in due course.
    - *Example*: In the above scenario, suppose Robert provides Sarah with a negotiable promissory note. This means that it is transferable without conditions. If Tim later presents the note for payment, Robert's defense against paying Sarah on the underlying contract does not apply to the promissory note. Robert will be liable if he fails to pay it. Robert may still sue Sarah, but this right is completely separate from his obligation on the promissory note.

- ***Discussion***: Can you explain the concept of holder risk in terms of negotiable and non-negotiable paper? Is there any reason that the issuer of the commercial paper may prefer the paper to be negotiable or non-negotiable? Why? What about the original holder of the negotiable paper?
- ***Practice Question***: Franklin receives a promissory note from Geo. The promissory note is transferable and Franklin immediately gives the note to Heath. Geo sues Franklin stating that he was defrauded into giving Geo the promissory note. How does this affect Heath's ability to receive payment on the promissory note?
- ***Resource Video***: http://thebusinessprofessor.com/negotiability-of-a-commercial-instrument/

5. What is required for commercial paper to be "negotiable"?

An instrument is negotiable if it meets the following qualifications:

- *Writing* - The instrument must be in writing,
  - *Note*: The writing must be permanent in nature and must be moveable.
  - *Example*: Drawing the terms of an instrument in the dirt would not be permanent, and spray painting the terms of an instrument on the side of a building would not be moveable.
- *Signed by Issuer* - The issuer must sign the instrument. A mark may constitute a signature if the issuer intends for the mark to be a signature.
  - *Example*: Valid marks constituting signatures may include seals, auto-pen signatures, personal stamps, etc.
- *Unconditional Promise to Pay* - The instrument must contain an unconditional promise to pay. A condition is any requirement that a holder must undertake before she has the right to present the paper for payment.
  - *Note*: The only acceptable condition is providing a time when the note becomes valid. That is, the note can state that it may only be presented for payment after a certain date. Further, any "acceleration" or "extension" clauses are valid and do not destroy negotiability. Reciting that consideration was provided for the instrument does not harm negotiability. Limiting the payment to a specific fund may destroy negotiability, unless it is an order instrument drawn on a specific account.
  - *Example*: "I promise to pay money to the order of bearer, if the bearer is a US citizen" is not an unconditional promise to pay.
- *Definite Amount* - The instrument must state a specific amount of money that it will pay.
  - *Note*: The promise cannot be to pay in anything other than money. If the instrument pays an interest rate, the interest rate may reference a standard rate for calculation.
  - *Example*: "Promise to pay $3,000 with interest of 3% + prime rate, compounding annually from the date of issuance" is a definite amount.
- *Payable on Demand or on Time* - A "demand instrument" must be paid whenever the holder requests payment, while a payable "on time" instrument indicates a specific date and time.
  - *Note*: An instrument that does not have a specific maturity date or payment time is assumed to be payable on demand.
  - *Example*: A note including the language, "payable on or before 90 days after October 15, 2017" is a definite time.

- *Payable to Order or To Bearer* - To be negotiable, an instrument must be either “order paper” or “bearer paper”. Order paper is payable to a specific individual. This individual’s signature is required if the instrument is transferred to another holder. Bearer paper means that any holder of the paper can present it for payment.
    - *Note*: Order paper can be converted to bearer paper with the holder’s signature (indorsement). A holder can also make bearer paper into order paper by signing and making a restrictive indorsement.
    - *Example*: “Pay to John or order” is order paper. “Pay to the order of ______” or “Payable to bearer” are examples bearer paper.
- *No Further Undertaking* - With limited exception, the instrument cannot require the holder to undertake any action other than present the instrument to receive payment.
    - *Note*: This is an extension of the requirement that the instrument contain an “unconditional” promise to pay.
    - *Example*: A holder, upon presentment, must post a temporary bond. This is a further undertaking that makes the instrument non-negotiable.

Remember, non-negotiable paper may still be transferred. The transferee of non-negotiable paper may have fewer rights than the holder of negotiable paper through a valid negotiation.

- ***Discussion***: Why do you think each of the above elements is necessary to make an instrument negotiable? Do you believe that any of these elements should be excluded or other elements added? Why?
- ***Practice Question***: Devon is debating whether to accept commercial paper from Clint as payment on a contract. The promissory note was created by a third party and used to satisfy a debt to Clint. It is payable on or after a specific date six months away. The Devon is worried about the liquidity of the instrument and whether the maker of the note has any defenses against its enforcement. Can you explain to Devon the requirements and benefits of a negotiable instrument?
- ***Resource Video***: http://thebusinessprofessor.com/requirements-for-commercial-paper-to-be-negotiable/

6. When does commercial paper contain an “unconditional promise to pay”?

Any condition placed on the payment makes the instrument non-negotiable. A condition is any requirement that a circumstance come to fruition or that the holder undertake any additional actions in order to receive payment upon presentation of the instrument.

- *Example*: I create a note that says, “I promise to pay to bearer or order the amount of $5,000. This amount will become payable if the NASDAQ drops below 4500 points.” This would be a condition to payment and would destroy the note’s negotiability.

- ***Discussion***: Why do you think the requirement that an instrument be free of conditions in its promise to pay the holder a stated sum of money? Should it matter the nature or extent of the condition? Why or why not?

- ***Practice Question***: Thomas and Carter are involved in a business deal. Carter sells Thomas a piece of equipment in exchange for a promissory note. In the note, Thomas agrees to pay Carter $25,000. He wants to add a clause stating that the note is invalid if the equipment malfunctions within the 1st year of operation. Does this clause affect negotiability and why?

- ***Resource Video*****:** http://thebusinessprofessor.com/unconditional-promise-to-pay/

7. What is "payable on demand" paper and "payable on time" paper?

A negotiable instrument must either be payable on demand or payment on time. An on-time instrument is payable at a specific time and date. The date must be able to be determined at the time the instrument is issued. It may be payable after an elapsed period of time that is readily ascertainable at the time the promise or order is issued, subject to rights of prepayment, acceleration, and extensions. If the instrument is not clear, but there is evidence of an intent to make it payable at a specific date and time, the note is not negotiable. An instrument is payable on demand if it states as much or it does not state any time of payment.

- ***Discussion***: Why do you think it is important to distinguish an instrument as "payable on time" versus "payable on demand"? Do you think these attributes affect the value or liquidity of a negotiable instrument? Why or why not?

- ***Practice Question***: Donovan receives a promissory note from Elvis. The note does not contain any date or time for payment. Is the note payable on time or demand?

- ***Resource Video***: http://thebusinessprofessor.com/negotiable-instruments-payable-on-time-or-on-demand/

8. What is "order paper" and "bearer paper"?

To constitute a negotiable instrument (both notes and drafts), an instrument must be either order paper or bearer paper.

- *Order Paper* - Order paper must include the words "pay to the order of (identified person)" or "to (identified person) or order". Including the word "order" indicates that the instrument is not limited to only one person. That is, the payee of the instrument can designate someone else to receive payment. This generally requires the identified person to indorse (sign) the instrument. Signing the instrument makes it bearer paper, unless the signor identifies a person to whom the instrument is being transferred.

    - *Note*: If the note is simply made out to pay a particular person without the word "order", it is not negotiable.

- *Bearer Paper* - If the commercial paper is made out "to bearer" or it is not made out to any specific person, it is bearer paper. It can be redeemed by any holder of the paper, subject to certain defenses.

- *Note*: Bearer paper may also use the wording "order". If the paper is made out to "order of gift" or "order of cash" or "pay to order of (blank space)" , it is bearer paper.

If all other requirements are met, the UCC provides an exception to the "order paper" or "bearer paper" requirement for commercial paper to be negotiable, but this exception *does not apply* to notes. Primarily, this exception applies to drafts drawn on third-party institutions that inadvertently leave off the "to order" language, but the nature of the paper is obvious.

- ***Discussion***: Why do you think it is important to identify whether the paper is order or bearer paper? Does it affect your opinion knowing that bearer paper can be converted to order paper and vice versa? Why or why not? Can you think of specific uses or order paper versus bearer paper? How does bearer paper limit the liquidity of the instrument? Should this affect the instrument's value?

- ***Practice Question***: Constance creates a promissory note that names Doug as the payee. Is this a negotiable instrument? What would need to be included to make the instrument negotiable order paper? What would need to be included to make the instrument negotiable bearer paper?

- ***Resource Video***: http://thebusinessprofessor.com/negotiable-instruments-order-or-bearer-paper/

9. How is a payee identified on the negotiable instrument?

A negotiable instrument is payable to the holder of the instrument. A holder may either be an individual named in the instrument (order paper) or an individual in possession of the instrument (bearer paper). An instrument that names a payee may name or identify the payee in any number of methods, including by name, identifying number, office, or account number. As a general rule, an instrument is payable to the person intended by the issuer, whether or not that person's correct name appears on the instrument. If the payee is identified only by account number, the instrument is payable to the owner of that account. If the payee is identified by account number and name, the instrument is payable to the named person whether or not that person owns the account. If the instrument is payable to "either Identified Person or Identified Person" (this may use the word "alternatively" or some derivative thereof), it may be negotiated or enforced by any or all of the named individuals. If the instrument is made out collectively to two or more individuals ("not alternatively"), it is payable to all of them and must be enforced by all individuals together. That is, all individuals must indorse the instrument for transfer or present it for payment. If it is ambiguous as to whether the paper is payable in the alternative, it is assumed to be payable alternatively.

- ***Discussion***: How do you feel about the rules for identifying a payee? Why do you think these requirements are in place? Does the fact that bearer paper does not identify a specific individual as payee affect your opinion? Should a negotiable instrument be able to identify a payee by methods other than name? Why or why not?

- ***Practice Question***: Ethan creates a promissory not and identifies the payee as "George or order". He then transfers the instrument to George Smith. Is this first name sufficient as an identifiable payee to make the instrument negotiable?

- ***Resource Video***: http://thebusinessprofessor.com/negotiable-instrument-how-is-payee-identified/

10. What rules does the court apply when determining negotiability?

The UCC favors negotiability of commercial instruments. It contains a number of rules to resolve any uncertainty as to the terms of the instrument and to supply missing terms. The following rules apply to situations where terms in a negotiable instrument contradict each other:

- words take precedent over numbers;
- handwritten terms prevail over typed and printed terms; and
- typed terms win over printed or boiler-plate terms.

These rules can allow for any number of general assumptions about the intent and obligations of the parties.

Example: If the applicable interest rate of a promissory note is left off, courts hold that a judgment rate applies.

- ***Discussion***: How do you feel about these generally applicable rules of interpretation for negotiable instruments? Is there any argument against the application of these rules?
- ***Practice Question***: Hank drafts a check to Ira that is drawn on First Bank. When Ira presents the check for payment, she realizes that the check indicates "Five-hundred dollars" and "5,000.00" in the amount column. What is the likely interpretation of First Bank's obligation to accept and pay the check?
- ***Resource Video***: http://thebusinessprofessor.com/negotiable-instrument-general-rules-of-interpretation/

NEGOTIATION OF AN INSTRUMENT

11. How is commercial paper negotiated to a holder?

"Negotiation" means that an instrument has been transferred (either voluntarily or involuntarily) to the holder by someone other than the issuer. If an individual acquires paper by a method other than negotiation, she is a "transferee" and not a "holder" of the paper. The paper is negotiated upon:

- transfer of possession, and
    - *Note*: The transferee may become a holder upon transfer. A holder must be entitled to enforce the instrument. This excludes individuals who forge a signature on order paper. They do not legally become a holder because the signature (a required element of negotiation of order paper) is not proesent. A thief or finder of bearer paper, however, may become a holder.
- indorsement (signature) by the holder.

- *Note*: Indorsement is not generally required for bearer paper, as the holder is not necessarily named on the instrument.

The holder of the instrument has the right to force the transferor to indorse the instrument. This is very important for purposes of enforcement and liability if the instrument is not paid when validly presented by a subsequent holder. That is, the indorser may be liable for paying an instrument that is dishonored when presented.

- ***Discussion***: Can you think of a type of transfer that does not constitute negotiation of order paper? What about bearer paper?
- ***Practice Question***: Linda writes a check drawn on First Bank and transfers it to Faye. Faye indorses the check and makes it payable to "Clyde". The check is stolen from the mail. The thief indorses the instrument in Clyde's name to make it bearer paper. Is the thief a holder of the instrument? Why or why not?
- ***Resource Video***: http://thebusinessprofessor.com/how-is-negotiable-instrument-negotiated/

12. What is the "transfer" of commercial paper?

An instrument is transferred when it is delivered by a person (other than its issuer) with the purpose of bestowing the right to enforce the instrument pursuant to its terms. Transfer vests in the transferee the rights of the transferor to enforce the instrument. While the transferee receives the rights of the transferor, it means the transferee may also be subject to any defenses the payor may have to payment of the instrument. That is, the transferee stands in the same position as the transferor with regard to the payor's defenses against payment.

- *Note*: As previously discussed, once transferred, the recipient of the bearer paper is a holder of the note. Even if the transfer is involuntary (inheritance or judicial order) or wrongful (theft of bearer paper), the individual in possession of the paper is a holder of the paper.

- ***Discussion***: What do you think about the mental intent necessary for transfer of an instrument? Why do you think the definition requires the intent to transfer the right to present and receive payment of the instrument?
- ***Practice Question***: Connie issues a promissory note that is payable to bearer. She gives the note to Todd. Todd then delivers the note to Judy. Do we have valid transfers of the instrument? What issues might Judy face in presenting the instrument for payment?
- ***Resource Video***: http://thebusinessprofessor.com/transfer-of-a-negotiable-instrument/

13. What is "indorsement" of a negotiable instrument?

Indorsement of an instrument means signing it. The indorsement signifies that the individual signing the instrument certifies certain things about it to the primary parties liable on the instrument (maker or drawer) and to any subsequent holder of the document.

- *Note*: Indorsement indicates that the instrument is payable in accordance with its terms. If the instrument proves not to be payable in accordance with its terms, this can lead to liability for the indorser.

If paper being negotiated is order paper (as apposed to bearer paper), the paper must be indorsed by the person to whom the paper is payable prior to transfer to another holder. Indorsement by the payee may change the paper from order to bearer paper (and vice versa), as well as put other limiting characteristics on the instrument. A payee may indorse the instrument to make it bearer paper or have a special/restrictive/qualified/anonymous indorsements to limit the rights of the future holder of the paper.

- *Note*: Indorsement of an instrument by an imposters and fictitious payee does not destroy a negotiation.

Indorsement is not always required for negotiation of the instrument. No indorsement is required to negotiate commercial paper if the paper in possession of the transferor is bearer paper. As such, the mere transfer of possession is a negotiation. In this case, even involuntary transfer (such as when the paper is lost or stolen) or voidable transfer (such as from an infant, through fraud, duress, misrepresentation,etc.) are sufficient to constitute negotiation.

- *Note*: When an instrument is made payable to two payees with the words "to A and B", signatures of both are required to negotiate it. Agency rules regarding actual and apparent authority apply to the indorsers.

- ***Discussion***: Why do you think order paper requires the indorsement of a holder to negotiate the instrument? Why do you think the same rule does not apply to bearer paper? Does it surprise you that indorsement entails a certification or warranty that the paper is payable?

- ***Practice Question***: Terry makes a promissory note that is payable to "Dan or order". He then transfers the note to Dan. What must Dan do in order to transfer the note to Arnie?

- ***Resource Video***: http://thebusinessprofessor.com/indorsement-of-a-negotiable-instrument/

14. What are the various types of indorsement of a negotiable instrument?

Indorsement is the signature of an individual on the commercial instrument. There are several common types of endorsement, each of which has a different effect upon the instrument:

- *Blank Indorsement* - This means signing the instrument without designating any particular payee or making any other form of limiting designation. A blank endorsement turns order paper into bearer paper.
    - *Example*: A promissory note is payable to "Frank or order". If Frank signs the promissory note, it is a blank endorsement that makes the paper enforceable by any holder.

- *Special Indorsement* - Special indorsement is a signature and instruction that limits the instrument to a particular person. A special indorsement may limit the indorser's potential liability, but is not effective to prevent further negotiation by the holder.

- *Example*: Isabelle writes “Pay Tom” or “Pay to the Order of Tom” on a note along with her signature. Remember, however, the the paper must contain “to order” to remain negotiable. Also, “Pay to the Order of Tom” establishes the paper as order paper, but it does not restrict Tom’s abilities. Tom can indorse the paper and negotiate it.

- *Restrictive Indorsement* - A restrictive indorsement includes the payee’s signature and instructions that limit the instrument to a particular use. Generally, a restrictive indorsement is not effective to prevent further negotiation of the paper. There are, however, special rules that apply to certain restrictive indorsements of checks.

  - *Note*: A conditional indorsement including words such as, "pay Tom if he washes my car" is ineffective. It does not qualify as a restrictive indorsement and does not limit negotiability.

  - *Example*: Signing the instrument and writing “For Deposit Only” is a restrictive indorsement on a check.

- *Qualified indorsement* - A qualified indorsement is an individual’s signature including the words, "without recourse”. The purpose of this form of indorsement is to limit the potential liability of the indorser who is transferring the instrument in the event the payor ultimately dishonors the instrument. The idea is that the indorser is transferring any rights she has in the instrument, but she is not warranting that the payor of the instrument will honor it. While this type of indorsement may limit the indorser’s liability to subsequent holders of the instrument, it does not affect or limit the ability to further transfer or negotiate the instrument.

  - *Example*: Darla is the payee on a note. She signs the note and writes “no recourse”. She then transfers the note to Dawn. Dawn cannot sue Darla to enforce or pay the instrument if the instrument is later dishonored by the payor at the time of presentment.

- *Anomalous indorsement* - This is an indorsement by someone other than the holder or transferor of the instrument. It is made to guarantee or incur surety liability on the instrument. This can give a transferee confidence in accepting the instrument. This type of indorsement is not necessary for negotiation.

  - *Example*: Neo is the payee of a note. He signs the note and seeks to transfer it Arthur. Arthur is comfortable in accepting the instrument. He agrees to accept the instrument when Mr. Gates agrees to sign the note. By indorsing the instrument, Mr. Gates is stating that the holder can seek payment of the instrument from him if it is first dishonored by the payor.

- ***Discussion***: How do you feel about the ability of an indorser to change the nature of the instrument? Should a qualified indorser be able to limit personal liability on the instrument? Why or why not? Can you think of situations when an anomalous indorsement would be common?

- ***Practice Question***: Kelly is the holder and named payee of a negotiable promissory note (order paper). She signs the note and writes the words “Pay Eric” and “Without Recourse”. What are the effects of indorsing the instrument with these additional instructions?

- ***Resource Video***: http://thebusinessprofessor.com/types-of-indorsement-of-a-negotiable-instrument/

LIABILITY - OBLIGATION OF PAYMENT

15. How does a holder of commercial paper receive payment of the instrument?

A negotiable instrument may be traded for value up until the time of payment. If there is no specified payment time, there is no limit on how long or how many times it can be negotiated to another party. A holder of the instrument may seek payment from a person obligated to pay the instrument through a process known as "presentment". Presentment is simply a demand made by a person entitled to enforce the instrument to an individual obligated to pay the instrument. The process for presenting a note for payment is slightly different than presenting a draft. The holder presents a note to the maker of the note, while a holder of a draft presents the draft to the third-party payor (such as a drawee bank). The person making presentment must exhibit the instrument, give reasonable identification, and surrender the instrument.

- *Note*: Presentment "duly made" means that presentment complied with all agreed requirements (location, time, etc.).

- ***Discussion***: Can you think of situations where presenting a note would be preferable to presenting a draft, and vice versa?
- ***Practice Question***: Mark is the holder and named payee of a promissory note and a check. What does he have to do to receive cash for the instruments?
- ***Resource Video***: http://thebusinessprofessor.com/presenting-a-negotiable-instrument-for-payment/

16. Who is potentially liable on (obligated to pay) a negotiable instrument?

The maker of a note or drawee of a draft is "primarily obligated" to pay the instrument. If the maker or drawee pays the note or draft, it is satisfied. If, however, the maker or drawee fails to honor the note or draft, anyone who held and then transferred the instrument may be liable to pay it. These third parties are "secondarily liable" to pay the instrument. By transferring the instrument, they warrant that the instrument being held is valid and payable. This is known as "transfer warranty". An individual who signs an instrument as indorser is also potentially liable to pay the instrument if it is dishonored. This is known as "indorser liability". Generally, an indorser is also a transferor and incurs potentially liability as a transferor and indorser; however, in some cases, a third party will indorse and instrument but not be a holder or transferor of the instrument. This is common when third parties are asked to co-sign or act as guarantor of the note. The warranties provided by transferors and indorsers of a negotiable instrument (and other parties potential liability to pay the instrument) are discussed separately.

- *Note*: Generally, a holder must present an instrument for payment and that demand must be denied before the holder can seek payment from an transferor or indorser.

- ***Discussion***: Why do you think the law makes transferors and indorsers secondarily liable on the instrument? How does transferor and indorser liability relate to the nature of a negotiable instrument?
- ***Practice Question***: Olivia is the holder of a note. She presents the note to the payor for payment. The payor

rejects the note and refuses to pay. What are Olivia's options for seeking payment?

- ***Resource Video***: http://thebusinessprofessor.com/liability-to-pay-a-negotiable-instrument/

17. When is an individual (including businesses) liable for a representative signing a negotiable instrument?

If a representative (an agent) signs a commercial instrument on behalf of a the represented person or business (the principal), the principal is bound and made liable by the representative signing either the principal's name or the agent's name. The representative is not liable on the instrument if:

- the form of the signature shows unambiguously that the signature is made on behalf of the represented person, and
- the instrument identifies the represented person.

This standard goes beyond the contract law standards for agent authority and principal liability.

- *Note*: Special rules apply for promoters of business entities that do not yet exist.

- ***Discussion***: Why do you think the standard for holding a principal liable for an agent's signature on a negotiable instrument is more broad than under agency law? Do you think an agent should have the ability to subject a principal to liability in the context of negotiable instruments? Why or why not? Should any additional regulations or other protections apply in this scenario?
- ***Practice Question***: Marshal is an agent of Clayton. Marshal signs a promissory note on behalf of Clayton and transfers it to Travis. What procedures must Travis have followed to make Clayton responsible for Marshal's actions?
- ***Resource Video***: http://thebusinessprofessor.com/liability-for-negotiable-instrument-signed-by-agent/

18. What rules apply if a holder of a negotiable instrument loses the instrument?

An obligor is generally only obligated to pay the instrument upon presentment. If an instrument is lost and has not been presented to the obligor for payment, the obligor may pay the instrument when the party losing the instrument requests payment (without actual presentment of the instrument). Paying the proper payee of a lost instrument will discharge the obligor's duty to pay the instrument, including satisfying the obligor's obligations to other parties who may find the lost instrument. To be entitled to payment of a lost instrument, the payee losing the instrument must prove:

- *Possession* - She was in possession and entitled to enforce when instrument was lost;
- *Accidental Loss* - The loss was not the result of transfer or lawful seizure;
- *Location Unknown* - The instrument's location cannot be determined; and
- *Instrument Terms* - She must provide adequate evidence of the terms of instrument.

Even if these condition are met, the payee must provide adequate protection, such as a surety bond, to protect the payor in the event the instrument is wrongfully paid.

- *Note*: State statutory or common law may provide a cause of action against and individual who has no property rights in an instrument but presents a lost instrument for payment. These state law protections are pursuant to property law and not part of the UCC.

- ***Discussion***: Why do you think the UCC allows for payment of a lost instrument? How do you feel about the obligation to pay a holder who finds lost bearer paper? Should there be additional protections under the UCC for holders who lose commercial paper?

- ***Practice Question***: Martin is the payee on a note. The note is negotiable, bearer paper. Martin indorses the paper with the purpose of transferring it to Fran. He somehow loses the paper. What must Martin do to seek payment of the note? Can Fran seek payment? What happens if Jason finds the note and presents it to the maker for payment?

- ***Resource Video***: http://thebusinessprofessor.com/lost-negotiable-instruments/

19. When is payment on a negotiable instrument overdue?

An instrument is overdue when the obligation to pay arises (upon presentment), but it has not been paid. An overdue instrument may give rise to a cause of action against a maker or drawee for failure to pay; also, it may make the instrument unenforceable as against a payor or drawee. When a negotiable instrument becomes overdue varies depending on whether the instrument is payable on time or on demand. A payable on demand instrument is overdue on the earliest of:

- the day after demand for payment is duly made;
    - *Note*: A negotiable demand instrument should be immediately payable. An extended delay in making payment violates the terms of payment.
- for a check, 90 days after its posted date; or
    - *Note*: Special rules apply to checks that do not apply to other drafts. A drawee bank is generally protected from liability if it refuses to honor a check that is 90 days past its posted date.
- after a period of time unreasonably long under the circumstances.
    - *Note*: With any demand instrument, an extended delay could affect payability of the instrument.

An instruments that is payable at a definite time is overdue the day after the due date for making the whole payment or payment of an installment. If the instrument requires presentment for payment, the instrument would be overdue the day after demand for payment is made. If the note has a clause calling for acceleration of all future payments upon default (such as becoming overdue), the document is overdue after the day established as the accelerated due date.

- *Note*: Default on interest payments on a note does not make the instrument overdue if there is no default in payment of principal and the due date has not been accelerated.

- ***Discussion***: Why is it important to understand when an instrument is overdue? Do you agree that an overdue instrument should affect the rights or obligations of the parties? Why or why not?

- ***Practice Question***: Corbin creates a promissory note payable on demand and issues it to Donald. If Donald presents the instrument to Corbin for payment, under what conditions is the instrument deemed overdue?

- ***Resource Video***: http://thebusinessprofessor.com/overdue-payment-of-negotiable-instrument/

20. What effect does a negotiable instrument have on the underlying obligation?

Most negotiable instruments arise pursuant to an underlying agreement, contract, or obligation. A maker or drawer creates the instrument and issues it to the holder in satisfaction of her obligation under an underlying agreement. For "ordinary instruments" the underlying obligation is merged and suspended until the negotiable instrument is payed. That is, the issuee may withhold performance of her obligation under the contract (such as delivery of goods) until the instrument is paid. An ordinary instrument is any instrument that does not qualify as a "near-cash instrument". If the commercial paper is a near-cash instrument, the maker or drawer's obligation is discharged at the time the instrument is accepted by the party to the underlying agreement. The idea is that these instruments are the equivalent of cash and thus satisfy the maker or drawer's obligation. Near cash instruments include certified checks, cashier's checks, and teller's checks.

- *Note*: If the holder of the ordinary instrument negotiates the instrument to a third party, the underlying contractual obligation is still not satisfied until the instrument is paid to the holder. If the instrument is not properly paid, the issuee may sue the maker or drawer on the note or the underlying obligation. A problem may also arise when the negotiable instrument only constitutes part of a party's payment obligation. In such a case, the underlying agreement is not fully discharged until the payment on the negotiable instrument satisfies the full obligation. In some situations, the parties will include a "paid-in-full" clause in the contract to indicate that payment of the instrument is in full satisfaction of the payor's obligation.

- *Example*: I agree to sell you a piece of equipment in exchange for a promissory note from you. I do not have the obligation to transfer ownership of the equipment to you until the promissory note is paid. If, on the other hand, I accept a cashier's check as payment for the equipment, your obligation on the underlying contract is satisfied (discharged). I would then be obligated to deliver the equipment.

- ***Discussion***: What do you think about the use and role of negotiable instruments as consideration in a contract? Why do you think an underlying obligation is suspended until the note is paid? Given the increased risk to the issuee of an instrument, does this affect the value of the transaction?

- ***Practice Question***: Oscar agrees to sell equipment to Nyesha. Nyesha creates an on-time promissory note payable to "Oscar or order". Is the contract fully executed (complete) when Nyesha transfers to the promissory note and Oscar transfers the equipment? Why? What are Oscar's options if Nyesha fails to pay the note in accordance with its terms?

- ***Resource Video***: http://thebusinessprofessor.com/negotiable-instrument-effect-on-underlying-contract/

HOLDER IN DUE COURSE

21. What is a "holder in due course" and what are the benefits?

If certain conditions are met, a holder of a negotiable instrument may further elevate her rights to enforcement (receive payment) of the negotiable instrument. That is, the holder of a negotiable instrument is elevated to a higher status than that of a simple holder if she qualifies as a "holder in due course" (HDC).

- *Recap*: As discussed above, the holder of an instrument is someone who possesses and is entitled to receive payment of an instrument. A holder may be the original recipient (issuee) of the instrument from the maker or drawer; or the issuee may transfer or negotiate the instrument to a third party who becomes holder. Recall that negotiation requires voluntary or involuntary transfer of the instrument and, if the instrument is order paper, indorsement by the payee. (A forger of paper cannot be a holder, while a thief of bearer paper can be a holder). An instrument is more valuable to the holder if it is negotiable.

Qualifying as a holder in due course (HDC) makes the negotiable instrument more valuable to the holder, as a HDC has a stronger right to payment of the instrument than an ordinary holder. If a holder is not a HDC, her rights in the instrument are the same as the original payee of the instrument prior to transfer. That is, her right to payment of the instrument depends upon the relationship between the issuer and the original payee. Upon receipt of the instrument, she inherits the rights of the original payee along with whatever claims and defenses that the maker or drawer has against the original payee arising out of the contract. HDC status makes the holder immune from these defenses at the time of presenting the instrument. HDC benefits are as follows:

- The payor of the instrument is estopped (stopped from) denying the validity of the instrument or asserting any personal defenses to payment of the instrument.

- The instrument may be purged of any defects that are not apparent to the holder in due course.

- The holder in due course may assert her right to payment against any prior indorsers or immediate transferor of the instrument if the instrument is dishonored (not payed) upon presentment.

Liability of transferors or indorsers of a negotiable instrument is discussed separately.

- ***Discussion***: Why do you think the UCC allows for the elevation of a holder's rights in an instrument? Do you think a holder should be insulated from a payor's defenses against payment?

- ***Practice Question***: Martha is a holder in due course of a promissory note. Gary is the payor of the note. She received the note from Sam. When she presents the note to Gary for payment, he rejects it based upon Sam's failure to perform the underlying contract. What are Martha's rights in pursuing payment of the instrument?

- ***Resource Video***: http://thebusinessprofessor.com/what-is-a-holder-in-due-course/

22. What are the requirements for a holder of an instrument to become a holder in due course?

To qualify as a HDC, the holder of the commercial paper must meet the following requirements:

- *Value* - The holder must take the instrument for value. This means that the holder must provide money or goods for the instrument. The transfer cannot be a gift or inheritance.

- *Good Faith* - The holder must receive the instrument in good faith. This means that the holder cannot have the intent to defraud anyone in receiving the instrument. It is easy to imagine any number of schemes in which a transferor would try to manipulate the law by transferring an instrument to a holder with a greater right to repayment.

- *Unaware of Defenses* - The holder cannot have notice that there is a valid defense to enforcement of the instrument. This is generally deemed to be actual notice, but constructive notice from the situation could disqualify the individual as well.

HDC status is determined at the time that the holder receives the instrument. If the holder meets the above requirement at the moment when she takes possession, she is a HDC. It does not matter if afterwards she learns of a potential defense. Each of the elements for HDC status is discussed separately.

- ***Discussion***: What do you think about the requirements to qualify as a HDC? Can you identify any objectives behind these requirements? Should there be more or less requirements? Why or why not?

- ***Practice Question***: Brad enters into a contract to purchase equipment from Claire. Brad issues a promissory note to Claire as payment. Claire delivers the equipment, but Brad believes that the equipment does not meet the standards represented in the contract. He demands that Claire replace the equipment or he will not pay the note if presented. Claire immediately sells the instrument to Doug, who is unaware of the dispute between Brad and Claire. If Doug refuses to pay the note when Doug presents it, what are Doug's rights? How does that affect Brad and Claire's position?

- ***Resource Video***: http://thebusinessprofessor.com/requirements-for-holder-in-due-course-status/

23. What does it mean to receive an instrument for value?

The holder must provide some form of value, such as assets, services, or money in exchange for the instrument. Receiving the instrument as a gift is not "for value". Value may also mean taking the instrument as payment of an antecedent debt, as consideration for a fully-performed contract, in exchange for another negotiable instrument, or in exchange for an irrevocable obligation. When exchanging the instrument for services or irrevocable obligations, the key characteristic is that the value must have already been provided. That is, there is no future obligation (such as a promise to sell goods or perform services) as part of the transfer for value.

- ***Discussion***: Why do you think the UCC requires that the holder exchange the instrument for value? Why do you think the value cannot be a future obligation? Is there any argument for allowing future obligations in certain instances?

- ***Practice Question***: Hannah issues a promissory note to Ilene. Ilene later enters into a contract to pay Juliet to paint her house. Ilene transfers the promissory note to Juliet as payment for Juliet's obligation to paint her house. Is Juliet a holder in due course?

- ***Resource Video***: http://thebusinessprofessor.com/holder-in-due-course-receive-instrument-for-value/

24. What does it mean to receive an instrument in good faith?

Receiving an instrument in good faith means acting in accordance with reasonable commercial standards and honesty in fact (no fraudulent intent in receiving the instrument). A holder must meet two tests to determine if good faith is present:

- *Subjective Tes*t - Did the holder believe the transaction was completed without the intent to defraud or deceive?

- *Objective Test* - Would a reasonable person believe the transaction to be commercially reasonable?

Note: The determination of good faith looks only at the recipient of the instrument in the transfer. The intent of the transferor is not considered in determining whether the recipient becomes a holder in due course. Some courts have held that a transferee lacks good faith when she is closely associated with the transferor.

- ***Discussion***: How do you feel about the good faith requirement for establishing HDC status? Do you think a subjective and objective test is adequate to identify good faith? Why or why not? Should the intent of the transferor be evaluated in this determination? Why or why not?

- ***Practice Question***: Darlene contracts with Gayle to provide design services. Darlene issues a promissory note to Gayle in the amount of $10,000 to pay for the services. Gayle owes about $1,500 to Martin. She transfers the instrument to Martin in full payment of her debt. Martin is aware that Gayle is not an honest business woman, but he accepts the promissory note. Gloria later leaves town without performing the services for Darlene. Martin presents the instrument for payment. What are Martin's right to payment of the instrument? What are Darlene's rights?

- ***Resource Video***: http://thebusinessprofessor.com/holder-in-due-course-receive-instrument-in-good-faith/

25. What does it mean to receive an instrument without notice of a valid defense to enforcement?

A recipient of a negotiable instrument cannot become a holder in due course if she is aware (or has "reason to know") that there are some valid defenses that the payor may assert against payment of the instrument. Remember, status as holder in due course would insulate the holder against these defenses. Valid defenses of the payor against payment of the instrument may include:

- *Overdue* - If the instrument has a stated time for payment and that time or date has passed, it is overdue.

    - *Example*: Checks are overdue 90 days after its posted date. A demand instrument is overdue the day after it is presented for payment or upon a reasonable time after it was issued. If the individual is subjectively aware that the instrument was presented for payment with no luck, that can indicate overdue status.

- *Dishonored* - If the instrument has been presented for payment and is dishonored.
  - *Example*: If the note or draft has been dishonored by the maker or drawee, there is a defect. Also, checks drawn on insufficient funds, once presented, cannot be transferred to a holder in due course.
- *Default on Collateral Instrument* - This generally arises when the instrument is issued as part of a series of transactions. Knowledge of an uncured default in another instrument issued as part of the same series is notice of a valid defense.
- *Instrument is Altered, Forged, or Incomplete* - An unauthorized alteration, unauthorized filling in of an incomplete instrument, or a forgery of an instrument is a valid defense against payment. Notice of these defenses may be actual or constructive. That is, if the name signed on the instrument is wrong or incorrect, this could be considered constructive notice of a valid defense.
  - *Note*: Remember that an alteration or completion of an incomplete (blank) note or check that is signed by an individual makes her liable for any amount filled in.
- *Notice of Claims or Disputes* - A valid defense includes when a third party has a claim to the instrument or there is a dispute between the original parties to the instrument. This places the risk on the maker or drawer responsible for creating the incomplete instrument.
  - *Example*: A party enters into two contracts where they purport to transfer the same promissory note as value. The other party's claim to the instrument is a valid defense against payment. Also, if the instrument was created as part of a contractual agreement, a dispute between the parties to the contract may be a valid defense to the instrument.

The UCC specifically excludes a list of individuals from HDC status based upon the manner in which they became holder of the instrument. Judgment creditors, bulk instrument purchasers, and heirs inheriting the instrument, for example, do not qualify as HDCs.

- ***Discussion***: Why do you think the UCC prevents HDC status for individuals aware of a defense to payment? Should it matter the nature of the defense (such as a weak or partial defense)? Why or why not? Why do you think the UCC specific excludes acquirers of the paper through judgments, debtor sales, and inheritance from HDC status?
- ***Practice Question***: Stacy issues a promissory note to Todd. Todd and Stacy have an argument regarding the underlying agreement and Stacy threatens to not pay the instrument. Todd agrees to sell the note to Unis at 50% of the value. Unis is familiar with the UCC and believes that she will qualify as a holder in due course? What rights will Unis have if Stacy denies payment on the instrument because of her contract dispute with Todd?
- ***Resource Video***: http://thebusinessprofessor.com/holder-in-due-course-notice-of-valid-defense/

26. How does discharge of the underlying obligation affect a holder in due course?

Negotiable instruments are generally created as consideration in a contract between two parties. That is, there is a contractual relationship (known as the underlying agreement) between the original creator (issuer) and recipient (issuee and holder) of the negotiable instrument. If the parties to the underlying agreement fail to carry out their obligations, it may affect the ability of a holder to later enforce the instrument against the payor. This is because the holder (as transferee) receives the same rights and the transferor. She also is subject to any defenses the payor may have against the issuee with regard to the underlying contract. A HDC, however, is not subject to the payor's personal defenses to payment of the instrument.

Pursuant to the above-stated rules, discharge of either party from her obligations under the contract giving rise to the negotiable instrument may serve as a defense to the payor having to pay the instrument. Discharge of the underlying obligation does not, however, affect the payment rights of a HDC who takes the instrument without notice of the discharge. While notice of discharge of the underlying obligation does not constitute "notice of a valid defense", it may affect the HDC's right to seek payment against the payor if the HDC received the instrument with knowledge of the underlying discharge.

- ***Discussion***: Why do you think discharge of the underlying obligation is not a defense to payment of a holder in due course of the instrument? Why does this rule change when the HDC has notice of the discharge prior to receiving the instrument? Should there be a distinction? Why or why not?

- ***Practice Question***: Venus and William enter into a contract. Venus issues a promissory note to William in consideration for William's obligation to perform services. William sells the promissory to Martina, who meets all of the requirements for a holder in due course. During this time, William is discharged from the contract due to a serious injury he suffered. Does this affect Martina's right to seek payment from Venus? If Martina sells the paper to Billy Jean and notifies her of the underlying discharge, would this discharge affect her right to seek payment?

- ***Resource Video***: http://thebusinessprofessor.com/holder-in-due-course-discharge-of-underlying-obligation/

27. What is the "Shelter Rule"?

Status as a holder in due course (HDC) may strengthen the rights of a holder to receive payment on a negotiable instrument. When a holder may not qualify as a HDC, the "shelter rule" is a separate principle that may protect her rights. Pursuant to the shelter rule, the transferee of a negotiable instrument receives all of the rights of the transferor of the instrument, unless the transfer is carried out by fraud or illegal means. This is important in situations where the transferor is a holder in due course, but the transferee is not.

- *Example*: A HDC may gift the negotiable instrument to the transferee. In this case, the transferee did not provide value for the instrument and does not qualify as a holder in due course. The shelter rule will allow the transferee to receive all of the rights of the transferor (a holder in due course) and receive the heightened protection. This rule makes the paper more marketable for the holder in due course.

The shelter rule provides liquidity to a HDC who, after accepting an instrument, learns of a defense against its enforcement. The HDC could validly transfer the instrument to another holder who has notice of the underlying defense.

The new holder would have the same rights as the HDC. It is important to note that, if a holder in due course learns that there is a valid defense against enforcement or that the underlying obligation has been discharged, she must disclose that information to the transferee who provides value for the instrument. If not, the transfer by the HDC to the new holder could be deemed fraudulent. This would destroy the shelter principle protections.

- *Note*: An exception to the shelter rule is that it does not apply if the holder in due course transfers the instrument back to a prior holder who was aware of its non-enforceable status and proceeded to transfer it to a holder in due course.

- ***Discussion***: How do you feel about the shelter rule? Are you convinced by the objectives of the rule? Are there any arguments against allowing the transfer of HDC rights to a non-HDC?

- ***Practice Question***: Tommy is a holder in due course of a promissory note. He learns that there is a dispute between the issuer and original holder regarding the underlying contract and one party has been discharged. He does not have the time and resources to seek payment of the instrument if it is contested. He sells the instrument to Olivia, who is confident that she can enforce the instrument. What are Olivia's rights with regard to enforcing the instrument?

- ***Resource Video***: http://thebusinessprofessor.com/shelter-principle-and-negotiable-instruments/

28. Can you limit holder in due course status?

In some situations, it is possible for the issuer of a note to limit the ability of anyone to whom the note is transferred to become a holder in due course. The Federal Trade Commission allows such a limitation for notes used in sales of goods. The note must have the proper language in the legend or footnoted that the paper may be subject to applicable defenses and a possessor is not a holder in due course. This action preserves the ability of the maker of the note to assert any defenses to payment (particularly those arising in the underlying agreement) against a later transferee of the note.

- *Note*: This is generally not available for drafts.

- ***Discussion***: Why do you think the FTC allows for the limitation of HDC status? Do you think that placing a legend is sufficient to protect the interests of a purchaser of an instrument? Why or why not?

- ***Practice Question***: Carrie is the issuer of a note used to pay for commercial goods. She is not certain about the contract and wants to limit the note being negotiated to a holder in due course. What are her options?

- ***Resource Video***: http://thebusinessprofessor.com/limit-holder-in-due-course-status/

29. Does a payor have any defenses to paying an instrument that is presented for payment by a holder in due course?

A holder in due course (HDC) has greater rights to enforce an instrument against the payor than does a mere holder of the instrument. The HDC is shielded from certain defenses against enforcement of an instrument. Generally, a payor may assert any number of "personal and real defenses" against enforcement of a note by a holder. The payor, however, can assert only real defenses, not personal defenses, against the holder in due course.

Personal Defenses - Personal defenses are generally defenses applicable to the underlying agreement or between the original parties to the underlying agreement. Common personal defenses are as follows:

- *Breach of Contract* - Any party to a contract who breaches the agreement cannot enforce payment of a negotiable instrument issued as part of that agreement.

- *Failure of a Condition* - Contracts may be subject to conditions precedent and subsequent. The occurrence or non-occurrence of which could discharge an individual from her obligations under a contract.

- *Lack or Failure of Consideration* - If the underlying contract fails for lack of consideration it may constitute a defense to enforcement of an instrument. Further, if a promissory note is given as a gift, it may be a defense against later enforcement. Since a gift promissory note is a promise to make a future payment, the obligation itself is not supported by consideration. The gift is the underlying payment, rather than the promise of payment. As such, it may not be enforceable for lack of consideration.

- *Mistake* - Bilateral and, in some cases, unilateral mistake in entering into a contract can affect enforceability of an agreement. This will serve as a defense against the enforceability of a negotiable instrument used as consideration for the agreement.

- *Waiver* - If a party to the underlying agreement waives the obligation of the other party (the party issuing the negotiable instrument), it can serve as a defense to enforcement of the instrument by the holder.

- *Prior Payment* - A note should be presented for payment, collected by the payor, and paid. If the note is paid, but not collected, it could fall into the hands of a subsequent holder. A subsequent holder of the instrument does not acquire the right of payment unless she qualifies as a holder in due course.

- *Theft of the Instrument* - Someone who steals a negotiable instrument may qualify as holder of the instrument. The payor may assert a defense against payment to a holder.

    - *Note*: A forger does not qualify has a holder.

- *Unauthorized Completion* - In some cases, a holder may be charged with completing or entering information on an instrument. Notably, if a holder receives blank or incomplete instrument and completes it in an unauthorized manner, this is a defense against that holder and any subsequent holder, unless she is a HDC.

    - *Note*: This does not include a forgery, which is a defense against an HDC.

- *Fraud in the Inducement* - Fraud in the inducement is when a party defrauds the other party in order to have her enter into the agreement. This normally means providing information that is untrue or deceptive information, but the information is not the subject matter of the contract.

- ***Resource Video***: http://thebusinessprofessor.com/personal-defenses-to-negotiable-instrument/

Real Defenses - Real defenses apply against any holder, including a holder in due course. Common real defenses are as follows:

- *Forgery* - The forger of an instrument or a payee's signature on an instrument is not a holder. As such, the non-holder cannot negotiate the instrument to a HDC.
  - *Example:* Agnes steals a check from Ben and forges his signature. She negotiates the check to Clark, who would otherwise qualify as an HDC if Clark were a holder. Agnes does not have to pay this instrument.
- *Bankruptcy* - Bankruptcy of the payor is a defense against holders and HDCs. The obligation to pay a negotiable instrument is considered a debt. This debt may be included in the debtor's bankruptcy estate. The holder or HDC must submit a claim for payment of the instrument to receive anything from the estate. Discharge of the debt discharges the obligation of the debtor to make payment.
  - *Example*: Agnes issues a promissory note. The note is transferred several times to multiple holders in due course. Agnes files for bankruptcy protection and her obligation to pay the instrument is include in the bankruptcy estate. An HDC would have to make an unsecured claim against the bankruptcy estate of Agnes or seek enforcement against a prior transferor or indorser.
- *Alteration* - Alteration is a limited defense against a holder and HDC. It may be a complete defense against a holder, but an HDC can enforce the instrument up to the original or correct amount of the instrument.
  - *Note*: If the instrument was blank and then filled out, the HDC can enforce it for the whole amount. This rule places the risk on the issuer who makes an incomplete instrument.
- *Duress, Mental Incapacity, Illegality* - Any of these typical contract defenses can also work against an HDC.
  - *Example*: Situations amounting to a defense against an HDC include where the issuer is subject to duress, has lost mental capacity due to disease, or the subject-matter of the contract is illegal due to a trade tariff. The underlying obligation must be void. If the underlying obligation remains voidable (rather than void), it is no defense.
- *Fraud in Fact* - Fraud in fact means that the subject matter of the contract involves an intentional deceit. This is different than fraud in the inducement.
  - *Example*: A seller intentionally makes false representations about the nature or quality of a good. This is fraud constituting the subject matter of the contract.

- ***Resource Video***: http://thebusinessprofessor.com/real-defenses-to-payment-of-negotiable-instrument/

- ***Discussion***: Why do you think defenses are separated into real and personal defenses? Are you convinced that each type of defense is appropriate against a holder or HDC? Should any personal defenses be effective against an HDC? Why or why not?

- ***Practice Question***: Taylor is the holder of a promissory note that is order paper. Smith steals the paper and forges Taylor's signature. He then transfers the note to Zora. If Zora presents the instrument for payment, what is the likely result?

30. What is a "claim in recoupment"?

A claim in recoupment is similar to a personal defense. It allows a payor to offset any claim that she has against the claimant or the original issuee.

- *Note*: A claim in recoupment applies against a holder, but not a holder in due course.
- Example: The payee on an instrument owes a debt to the named payor. If a subsequent holder presents the instrument for payment, the payor may offset that claim against payment to the holder. If, however, the payee is a holder in due course, the payor cannot offset that claim.

- ***Discussion***: Why do you think a claim in recoupment is enforceable against a holder but not a HDC? Do you agree with this?
- ***Practice Question***: Evan enters into a contract with Frank. As part of the contract, Evan issues a promissory note to Frank. Frank fails to fully perform some immaterial aspects of the contract. This entitles Evan to offset of the payment price owed to Frank. If Frank presents the note for payment, what is the result? What if he trades the note to Ernest, who qualifies as an HDC?
- ***Resource Video***: http://thebusinessprofessor.com/claim-in-recoupment-applicable-to-negotiable-instrument/

31. What are the rights of a holder in due course if the underlying transaction is a consumer transaction?

There is a broad exception to the heightened rights afforded a holder in due course if the instrument is issued pursuant to a consumer transaction. This situation generally arises when a consumer of a good signs a note promising to pay the debt arising from purchase of the good. It may not be fair to force a consumer who writes a note to have to pay a third-party, holder in due course if the underlying contract is breached. As such, the Federal Trade Commission and some states require consumer credit contracts (and sometimes consumer promissory notes) to contain the designation "consumer paper". This designation makes the instrument non-negotiable. As such, no one can be a holder in due course under the UCC.

- *Note*: If the language is omitted, a holder of the note can be an HDC, but the original seller of the note can be subject to fine.

- ***Discussion***: Do you agree with granting an exception to negotiability of consumer paper? Do you think the label, "consumer paper" is sufficient notice to a holder that the paper is non-negotiable?

- ***Practice Question***: Carter owns a store selling personal lawn equipment. Winston purchases a lawn mower for his personal use. He signs a promissory note as consideration for the mower. Carter wants to liquidate some of his accounts receivable and sell the promissory note from Winston. Can you explain to him the rules that apply in this situation?

- ***Resource Video***: http://thebusinessprofessor.com/holder-in-due-course-consumer-transactions/

32. What is the result if a negotiable instrument is forged?

A forged negotiable instrument is not enforceable against the party whose name was forged. The forged instrument is, however, enforceable against the forger. Basically, the instrument is treated as though the forger signed her own signature. Also, a forged negotiable instrument puts affirmative duties on parties implicated in the forgery. For example, a drawee bank on a forged check must use ordinary care in inspecting a potentially forged signature when paying check. The owner of the check may be liable if the check is stolen and forged because of her own negligence. The owner has a duty to verify records to identify forged instruments. The drawer is barred from contesting improper payment of the check by a one-year statute of limitations.

- ***Discussion***: How do you feel about the ability to enforce a forged instrument against the forger? What do you think about the additional responsibilities placed upon the parties?

- ***Practice Question***: Cathy is an employee of ABC Corp. She steals a check from the company, signs her manager's name, and makes the check out to herself. The check is drawn on ABC's account at First Bank. She then indorses the check and transfers it to Doris. Doris presents the check to First Bank for payment. Who is potentially liable on the check?

- ***Resource Video***: http://thebusinessprofessor.com/forged-negotiable-instrument-and-holder-status/

33. What is the result if a negotiable instrument is stolen?

A negotiable instrument made out to a specific individual is order paper. If the instrument is stolen, the thief can only transfer it by altering or forging the payee's signature. As such, a transferee of stolen, forged order paper is not a holder or holder in due course and therefore does not take free of the payor's defenses. Bearer paper, on the other hand, may be transferred by anyone in possession of the instrument. A thief can negotiate stolen bearer paper to a holder. A holder of the paper would be subject to a payor's personal defenses or a claim by a payee that the instrument was stolen. In contrast, a holder in due course of stolen bearer paper takes the instrument free of the claims of the payor that it was stolen.

- *Note*: Special rules apply when the theft of the negotiable instrument is carried about by an agent (such as an employee) of the payor. If an agent misappropriates an instrument, the principal may be liable on the instrument based upon the authority of the agent. The principal has a claim to the instrument or its proceeds against the agent and subsequent takers unless a subsequent transferee is a holder in due course.

- ***Discussion***: How do you feel about the ability of a HDC who receives an instrument from a holder to enforce the instrument? Why does it matter whether the thief is also a forger? Should the interests of the payor be balanced against the interest of the HDC in this situation? Why or why not?

- ***Practice Question***: Eric executes a promissory note payable to "Amanda or order". Tommy steals the note and endorses Amanda's name. He then sells the note to Max, who is unaware of the forgery. What is Eric's obligation to pay the instrument? What rights does Amanda have? What are Max's rights?

- ***Resource Video***: http://thebusinessprofessor.com/stolen-negotiable-instrument-and-holder-status/

34. What is the role of a guarantor or surety of a negotiable instrument?

A guarantor (also known as a surety or co-signor) serves to add certainty of payment of a negotiable instrument. A guarantor of a note or draft is an "accommodation party" who signs the instrument as an indorser. There are a couple of forms of guarantor, as follows:

- *Guarantor of Payment* - A co-maker's accommodation indorsement guarantees payment. The holder may demand payment from her without first seeking payment from other co-maker.

- *Guarantor of Collection* - A collection guarantor is an accommodation party who is liable only if a judgment is rendered against a payor and the judgment is uncollectible against the debtor or is returned unsatisfied.

- ***Discussion***: Why do you think the UCC provides for a distinction between a guarantor of payment versus a guarantor of collection?

- ***Practice Question***: Sara makes a promissory note payable to "Dave or order". Dave does not want to accept the note from Sara because of her poor credit history. Angela, who has excellent credit, agrees to cosign the note to add certainty. What are the rights of the parties in this situation?

- ***Resource Video***: http://thebusinessprofessor.com/guarantor-or-surety-of-a-negotiable-instrument/

35. What is an "accord and satisfaction"?

An accord and satisfaction is a resolution of a contested debt. For example, the payor and holder of a negotiable instrument may have a dispute as to the amount and duty of payment of the instrument. Often a payor of the debt will offer a lesser amount than what is claimed by the holder in full satisfaction of the debt owed. This is an offer of settlement of the disputed debt. An instrument that purports to be full payment for an obligation will discharge an obligation if certain requirements are present:

- *Good Faith* - One party, in good faith, tenders an instrument to the claimant as full satisfaction of the claim;

- *Bona Fide Dispute* - The amount of the claim is subject to a *bona fide* dispute;

- *Payment Accepted* - The party receiving the offer of settlement obtains payment of the instrument; and

- *Adequate Notice* - The instrument or accompanying written communication contains a conspicuous statement to the effect that the instrument is tendered as full satisfaction of the claim.

A creditor receiving an offer of accord and satisfaction who inadvertently accepts the payment (not aware of accord language), upon learning of the other party's intent, may make or offer repayment within 90 days of receipt.

- ***Discussion***: Why do you think the UCC allows for the "accord and satisfaction" of a disputed payment obligation under a negotiable instrument? Are the prerequisites for a valid accord and satisfaction adequate? Why or why not? Can you think of any other necessary requirements?

- ***Practice Question***: Cathy enters into a contract with Bernice. A dispute arises as to each party's performance of the agreement. Cathy sends a check to Bernice with "accord and satisfaction" printed on the check. What is else is required to effect a valid accord and satisfaction of the disputed debt?

- ***Resource Video***: http://thebusinessprofessor.com/negotiable-instrument-accord-and-satisfaction/

LIABILITY AND WARRANTIES FOR NEGOTIABLE INSTRUMENTS

There are two main types of liability on a negotiable instrument - primary and secondary liability. The maker of a note and drawee of a draft are primarily liable to pay the instrument. Parties who later sign, transfer, or present an instrument may be secondarily liable to pay the instrument. Secondary liability is conditioned upon the note or draft being dishonored upon presented for payment to the primarily liable party. When a payor dishonors an instrument, the holder may seek payment from third parties who previously signed or transferred that instrument. The ability to receive payment from previous signors and transferors is based upon theories of warranty. These individuals, in certain circumstances, warrant to later transferees or holders that the instrument is valid and payable.

- ***Discussion***: What do you think about the system of primary and secondary liability on a negotiable instrument? Why do you think the UCC allows for secondary liability? How does the affect the liquidity and value of the instrument?

- ***Resource Video***: http://thebusinessprofessor.com/liability-for-warranties-of-negotiable-instrument/

36. What is "drawer or maker liability" for a negotiable instrument?

A drawer of a draft orders that at third-party drawee pay a specific amount to a payee who presents the instrument. The drawer, as creator of the instrument, is liable if the drawee dishonors (refused to pay) the draft. Likewise, a maker of a note is liable to a holder who presents the note for payment. If a maker or drawer wrongfully refuses to pay the instrument, any person entitled to enforce the instrument or any indorser who paid the instrument may sue for wrongful dishonor.

- *Example*: Harry writes a check drawn of First Bank to Ira. If First Bank refuses to pay the check, Ira may present it to Harry for payment. If Harry writes a note to Ira, he is liable to pay the note when validly presented by a holder. In either situation, if Harry refuses to pay the draft or note, Ira may sue for performance. If Ira transfers the instrument to a later holder, the holder would be able to sue if Harry fails to pay. If Ira or a later holder received payment on the instrument from a previous holder or transferor of the instrument, the individual paying the instrument may seek reimbursement or payment from Harry.

- ***Discussion***: How do you feel about the ability of any holder or payor of an instrument to seek payment of an instrument from the maker or drawer? What objective does these rules serve?
- ***Practice Question***: Ida issues a promissory note to Jim. Jim negotiates the note to Kyle. Kyle presents the note for payment and Ida refuses payment. What are the rights of Ida and Kyle in this situation?
- ***Resource Video***: http://thebusinessprofessor.com/drawer-or-maker-liability-to-pay-negotiable-instrument/

37. What is "transferor warranty" of a negotiable instrument?

A transferor of a negotiable instrument warrants the following to the recipient of the instrument:

- *Good Title* - The transferor has good title to the instrument;
- *Enforceability* - The transferor is entitled to enforce the instrument;
- *Authorization* - All signatures are authorized and authentic;
- *Alterations* - There have been no alterations to the instrument;
- *Defenses* - There are no defenses to enforcing the instrument; and
- *Solvency* - The transferor does not know the payor to be insolvent.

Transfer warranties apply when the transferor transfers the instrument for consideration. The new holder only receives transfer warranties from an immediate transferor. Thus, a holder cannot enforce the instrument pursuant to transfer warranty against anyone who transferred the instrument without consideration or did not directly transfer the instrument to her.

- *Note*: A payor bank of a draft does not receive transfer warranty, as the instrument is presented to the bank, rather than transferred. Presentment warranty is discussed separately.

- ***Discussion***: How do you feel about the warranties provided by the transferor of a negotiable instrument? Are these warranties adequate? Why or why not? Can you think of any other warranties that should be included? Why do you think these warranties are limited to situations where the instrument is transferred for value? Should these warranties apply to prior transferors (as apposed to the immediate transferor)?
- ***Practice Question***: Leena is the holder of a note. Leena transfers the note to Kate for $100. Kate then transfers the note to Jean for $110. What transfer warranties apply to each of the parties?

- ***Resource Video***: http://thebusinessprofessor.com/transfer-warranty-of-negotiable-instrument/

38. What is "indorser warranty" of a negotiable instrument?

An indorser of an instrument makes warranties to the maker or drawer of an instrument and to subsequent holders of the instrument. Assurances to the marker or drawer include:

- *Good Title* - She has good title to the instrument,
- *Forgery* - She has no knowledge of forgery, and
- *Materially Altered* - The instrument is not materially altered.

An indorser warrants to a subsequent holder that:

- *Good Title* - She has good title,
- *Signatures* - All signatures are genuine,
- *Alterations* - The instrument is not materially altered,
- *Defenses* - There are no known defenses against payment of the instrument, and
- *Insolvency* - There is no knowledge of the maker or drawer's bankruptcy.

Liability for a failure of these assurances is known as "indorser liability". The difference between indorser warranties and transferor warranties is that any good-faith holder of the note may enforce these warranties against any indorser. Recall, transfer warranties are limited to the immediate transferor. Indorser warranties make the indorser (signor) of an instrument secondarily liable to a holder. That is, the indorser is liable to pay an instrument that has been dishonored. An indorser who pays the instrument is left to seek reimbursement from a prior indorser or anyone who transferred the instrument to her.

- *Note*: Indorser liability can be disclaimed by the indorser at the time of indorsement. Generally, the disclaimer must be noted on the instrument. Disclaimer is not available for checks. The maker or drawer of a note or draft does not incur indorser liability or transferor liability. These individuals are primarily liable on the instrument.

- ***Discussion***: Why do you think the UCC allows a holder of a dishonored instrument to seek payment from any prior indorser? Is this situation fair to a prior indorser? Why or why not? Why do you think these protections are necessary given the existence of transferor warranties?

- ***Practice Question***: Victor is the holder of a note drawn by Russ and payable to "Victor or order". Victor signs the instrument and negotiates it to "Waylon or order". Waylon later signs the instrument and negotiates it to Yvonne. Yvonne presents the note to Russ for payment and it is dishonored? Yvonne does not want to sue Russ to enforce the instrument. What are her options for seeking payment of the instrument?

- ***Resource Video***: http://thebusinessprofessor.com/indorser-liability-for-negotiable-instrument/

39. What is "presentment warranty" of a negotiable instrument?

Presentment warranty applies when a person entitled to payment of an instrument presents it to a maker or drawee for payment. The presenter warrants to a good faith payor the following:

- *Enforceability* - She is entitled to enforce the instrument,
- *No Alterations* - The terms of the instrument are genuine and there have been no alterations, and
- *No Forgeries* - The drawer of the instrument's signature is genuine.

Presentment warranties generally apply to drafts, as all drafts must be presented for payment. This warranty is broader than the name implies. A payor of an instrument can enforce these warranty provisions against the presenter and all prior transferors of the instrument. The theory is that any transferor of the instrument represents that the instrument may be presented for payment in accordance with the above warranties.

- *Note*: Presentment warranty may be disclaimed in certain drafts, but cannot be disclaimed for checks.

- ***Discussion***: Why do you think the UCC allows for presentment warranties? What gap does this fulfill in protection of holders of a draft or note? Are these protections adequate? Why or why not?
- ***Practice Question***: Ellen is the holder of a check written by Darla and drawn on First Bank. She received the check from Ed, who received it from Clark, the original issuee. If Ellen presents the check to First Bank, what is she warranting to the bank? If First Bank accepts and pays the check and it turns out that Ellen was not entitled to payment, what are First Bank's options for recovering the funds paid?
- ***Resource Video***: http://thebusinessprofessor.com/presentment-warranty-of-a-negotiable-instrument/

40. To what extent is a warrantor liable for damages suffered by a holder of a dishonored note or draft?

An individual presenting a draft or note for payment that is dishonored may recover damages from a prior warrantor of the instrument. That is, a person receiving an instrument in good faith and subject to warranties may recover from the warrantor an amount equal to the loss suffered as a result of the dishonor. The holder may recover the amount payable on the instrument, plus expenses and loss of interest incurred as a result of the dishonor.

- *Note*: The amount of potential recovery from a warrantor is limited if the claimant received partial payment of the instrument. For example, a drawee receiving presentment warranty may recover from a warrantor damages for breach of warranty equal to the amount paid by the drawee, less the amount the drawee received or is entitled to receive from the drawer because of the payment, plus any expenses and loss of interest resulting from the breach.

- ***Discussion***: Do you agree with the principle that an individual enforcing an instrument against a warrantor should be able to receive expenses and losses from the dishonor? Should the rights of the warrantor be balanced against the rights of the claimant? Why or why not?

- ***Practice Question***: Pam is the holder of a check for $5,000 that she received from Tom. Pam presents the check to First Bank and it is dishonored. Pam seeks to enforce the instrument against Tom based upon transferor warranty. She incurs $350 in court fees in an effort to enforce the instrument. What amount may Pam recover from Tom?

- ***Resource Video***: http://thebusinessprofessor.com/warrantor-liability-on-negotiable-instrument-damages/

41. Is there a time limitation for exercising warranties on negotiable instruments?

The holder of an instrument must make a warranty claim to a warrantor within 30 days of notice of dishonor of the instrument. Failure to give this notice within 30 days may relieve the warrantor from liability for any losses incurred as a result of the failure of the claimant to give timely notice.

- *Example*: Emily is the holder of a draft drawn on ABC Financial. She received the draft from Clayton. Emily transfers the draft to Doug. The draft is subsequently transferred multiple times. Eventually, Easton presents the draft for payment. ABC pays the draft and then learns that Easton was not validly entitled to payment. ABC seeks to recoup the money paid from Easton, the presenter of the draft. When Easton and other transferors cannot be found, ABC attempts to enforce the instrument against Emily. ABC waits longer than 30 days to give Emily notice of its claim. This delay caused Emily to not be able to recover from Clayton, who she recently paid money she owed. She would have been able to offset the amount owed if she had been given timely notice. Her obligation to pay ABC on presentment warranty may be discharged due to her loss caused by ABC's delay in providing notice of its presentment claim.

- ***Discussion***: Why do you think the UCC allows for a discharge of liability on a presentment claim for losses incurred because of late notification from a claimant seeking to enforce the instrument based upon warranty? What objectives are being served? Do you agree with this principle? Why or why not?

- ***Practice Question***: Tim presents a draft created by Stacy and drawn upon First Credit Union. Tim acquired the draft from Elvis. First Credit Union pays Tim and then learns that Tim was not entitled to payment. First Credit Union is able to recover from Tim on the basis of presentment warranty. Tim seeks to recover from Elvis based upon transferor and presentment warranties. Tim fails to give Elvis notice of his claim within 30 days of learning of the First Credit Union's dishonor. What does this mean for Tim and Elvis' rights?

- ***Resource Video***: http://thebusinessprofessor.com/warranty-liability-negotiable-instrument-time-limitations/

42. When are the warranties of a negotiable instrument discharged?

Transferor, indorser, and presenter liability is discharged by any manner that would effectively discharge a party's obligation on a contract at common law. These provisions may relieve the obligation of a payor or payee, but could still subject transferors or indorsers to liability.

- *Note*: Indorser and accommodation party liability may be discharged by the same means that a surety's liability is discharged.

- *Example*: Valid payment discharges the obligations of payor of a negotiable instrument. Other methods include tender of payment and refusal, cancellation or renunciation of the obligations, material and fraudulent alteration of the instrument, certification, acceptance varying a draft, reacquisition, and, in some cases, unexcused delay in giving notice of presentment or dishonor.

- ***Discussion***: Why do you think payment of a negotiable instrument relieves that party's warranty liability? Would it be fair to subject a payor to double liability for payment of an instrument? Why or why not?

- ***Practice Question***: Leon receives a promissory note made by Raymond as part of a contract. Leon transfers the note, which is subsequently transferred numerous times before it comes to Linda. Linda submits the instrument to Raymond for payment and it is dishonored. Linda seeks to enforce the instrument against Leon. Leon pays the instrument? What is Leon's remaining responsibility on the instrument? Under what situations would Raymond be relieved from his obligation to pay Raymond on the instrument?

- ***Resource Video***: http://thebusinessprofessor.com/discharge-warranties-negotiabl-instrument/