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Business Law 220 – The Law of Contracts

Weekly Information Sheet 11

Commercial Paper

Negotiable Instruments:

Defined: Section 3-104(a)(1) and (2) of the UCC defines a negotiable instrument as:
"an unconditional promise or order to pay a fixed amount of money, … if it
(1) is payable to Bearer or order…;
(2) is payable on demand or at a definite time; and
(3) does not state any other undertaking or instruction … to do any act in addition to the payment of money"

Simple Definition:

A negotiable instrument is a record of a signed promise or order to pay a specified sum of money.

The Purpose of Negotiable Instruments

Generally: For convenience, and as a way to facilitate transactions, businesses accept certain kinds of paper called commercial paper or negotiable instruments.

A Money Substitute: Commercial paper is accepted as a substitute for money, or as a means of offering credit. Negotiable, commercial paper is thereby created for the purpose of facilitating the transfer of funds and payment in business transactions.

Types of Negotiable Instruments:

Generally: There are two categories of negotiable instruments:

- ***Promises to Pay:*** These include promissory notes and certificates of deposit; and
- ***Orders to Pay:*** These include drafts and checks.

Specific Negotiable Instruments:

- ***Promissory Notes:*** A promissory note is a written promise made and signed by the maker to pay a sum certain in money to the holder of the instrument.
- ***Certificates of Deposit:*** A certificate of deposit is a written promise to pay issued by a bank, and through a CD, a bank acknowledges the customer's deposit of a specific sum of money, and promises to pay the customer that amount deposited, plus interest, when the certificate is surrendered.
- ***Drafts:*** A Draft, or Bill of Exchange, is a written, unconditional order, by one person upon another, signed by the person giving it, and ordering the person to whom it is directed, to pay upon demand, or at a definite time, an amount certain, in money, to order or to bearer.
- ***Checks:*** A check is defined as "a draft, other than a documentary draft, payable on demand and drawn on a bank." A check, therefore, is an order by a depositor (the drawer) on a bank or credit union (the drawee) to pay a sum of money to the order of another party (the payee).

  Types of Checks:
  - An **Ordinary Check** is drawn by the bank upon a depositor's account.
  - A **Cashier's Check** is a draft drawn by a bank on itself.
  - A **Teller's Check** is a draft drawn by a bank on another bank in which it has an account.
  - A **Traveler's Check** is a check that is payable on demand, provided it is countersigned by the person whose signature was placed on the check at the time the check was purchased.
  - ***Money Orders*** are issued by both banks and nonbanks. A ***Money Order*** drawn by a bank is also a check.

Parties to Negotiable Instruments:

Maker: The maker is the party who writes or creates a promissory note, thereby promising to pay the amount specified in the note.

Drawer: The drawer is the party who writes or creates a draft or check.

Drawee: The drawee is the party to whom the draft is addressed and who is ordered to pay the amount of money specified in the draft. The bank is the drawee on a check, and the credit union is the drawee on a share draft. A drawee on a draft has no responsibility under the draft until it has accepted that instrument.

Payee: The payee is the person named in the instrument to receive payment.

Acceptor: When the drawee of a draft has indicated by writing or record a willingness to pay the amount specified in the draft, the drawee has accepted liability and is called the acceptor.

Secondary Obligor (Accommodation Party): When a party who is not originally named in an instrument allows their name to be added to it for the benefit of another party, in order to add strength to the collectability of the instrument, that party becomes a secondary obligor (formerly called an accommodation party) and assumes a liability role. The UCC now refers to drawer, endorsers, and accommodation parties as "secondary obligors".

Negotiability:

Defined: Article 3 of the UCC determines whether an instrument is Negotiable. If an instrument is negotiable, it is governed by Article 3 of the UCC, and it may be transferred by negotiation. *"Negotiation"* is "a transfer of possession, whether voluntary or involuntary, of an instrument, by a person, other than the issuer, to a person who thereby becomes its holder."

Purpose of Negotiability: Negotiability, as a form of transfer, permits the transferee to acquire rights greater than those afforded assignees of contracts under contract law. The quality of negotiability in instruments creates opportunities for transfers and financings that streamline payments in commerce. Transfers can be made with assurance of payment without the need for investigation of the underlying contract.

Requirements of Negotiability: Negotiability has certain fundamental requirements. To be negotiable, an instrument must be:

In Writing: The instrument must be evidenced by a record;

Signed: The instrument must be signed (authenticated) by the maker or the drawer;

A Promise or Order to Pay: The instrument must contain an unconditional promise or order to pay;

An Amount Certain: The instrument must pay a sum certain;

Payable in Money: The instrument must be payable in money;

Payable on Demand or at a Defined Time: The instrument must be payable on demand, or at a definite time; and

Payable to Order or Bearer: The instrument must be payable to order or bearer, using what are known as words of negotiability

Ambiguous Language: Ambiguous language is language that has more than one reasonable interpretation. The following rules are applied when ambiguous language exists:

- ***Words control figures where conflict exists;***
- ***Handwriting supersedes conflicting typewritten and printed terms; and***
- ***Typewritten terms supersede preprinted terms***

Statute of Limitations: Article 3 of the UCC establishes a three-year statute of limitations for most actions involving negotiable instruments. **(2)**

Transfers, Problems and Warrantees:

Definitions:

Holder: A **Holder** of a negotiable instrument is someone in possession of a negotiable instrument that runs to that person (i.e., the instrument is made payable to that person, is indorsed to that person, or is bearer paper).

Holder in Due Course: A **Holder in Due Course** is a holder who has:

- ***given value for the instrument;***
- ***taken the instrument in good faith;***
- ***Has no knowledge that the instrument will be dishonored, or that it is overdue; and***
- ***Has no knowledge of any defenses to the instrument.***

A holder in due course is accordingly afforded special rights and status.

Transfer of Negotiable Instruments:

Ease of Transfer: Negotiable instruments are transferred by the process known of negotiation. Much of the commercial importance of negotiable instruments lies in the ease with which they can be transferred.

Effect of Transfer:

Rights of the Transferor are Given to the Transferee: When a contract is assigned, the **transferee** has the rights of the transferor. Thus, the transferee is entitled to enforce the contract but, as assignee, has no greater rights than the assignor. This is because the assignee is in the same position as the original party to the contract, and is subject to any defense that could be raised in a suit on an assigned contract.

Transferee Becomes the Holder: When a negotiable instrument is transferred by negotiation, the transferee becomes the **holder** of the commercial paper. A holder who meets certain additional requirements may also be a **holder in due course.** The status of a holder in due course gives immunity from certain defenses that might have otherwise been asserted against the transferor.

How Negotiation Occurs:

The Order or Bearer Character of the Paper: The order or bearer character of the paper determines how it may be negotiated.

Determined By Language on the Instrument: The order or bearer character of an instrument is determined according to the words of negotiability used.

Determined at the Time of Transfer: The character of an instrument is determined as of the time negotiation takes place, even though its character originally may have been different.

Order Instruments: Instruments that qualify as order paper have a ***named payee*** on the instrument.

Bearer Instruments: Instruments that qualify as bearer paper are those **payable to bearer** or **"cash"**.

Indorsements:

Indorsement: The signature of the payee on commercial paper is known as an indorsement.

Defined: Black's Law Dictionary defines and indorsement as "The placing of a signature, sometimes with an additional notation, on the back of a negotiable instrument to transfer or guarantee the instrument or to acknowledge payment."

Indorser: The person making the indorsement on the commercial paper is known as the indorser.

Indorsee: The person to whom the indorsement is made on the commercial paper is known as the indorsee.

Types of Indorsements: Indorsement and transfer of possession can be made by the payee or indorsee or by an authorized agent of that person. Although words of negotiability are required on the front of negotiable instruments, it is not necessary that indorsements contain the word ***order*** or ***bearer***. Indorsements include the following types:

Blank Indorsement: A Blank Indorsement is an indorsement that does not name the person to whom the paper, document of title, or investment security is negotiated.

Special Indorsement: A special indorsement is an indorsement that specifies the person to whom the instrument is indorsed.

Qualified Indorsement: A qualified indorsement is an indorsement that includes words such as "without recourse" that disclaims certain liability of the indorser to a maker or a drawee.

Restrictive Indorsement: A restrictive indorsement is an indorsement that restricts further transfer, such as in trust for or to the use of some other person, is conditional, or for collection or deposit.