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Business Law 220 – The Law of Contracts

Weekly Information Sheet 13

Commercial Paper - Continued

Parties to Negotiable Instruments:

Definitions:

Assignee: An Assignee of a negotiable instrument is a third party to whom contract benefits are transferred.

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.

Rights of Parties to Negotiable Instruments:

Rights:

Assignee: Any assignee has all of the rights given through and under the negotiable instrument. Their rights are no different from the rights of an ordinary holder.

Holder: Any holder has all the rights given through and under the negotiable instrument. paper). These rights include a right of payment, as well as a right of discharge, release and recovery.

Holder in Due Course: A Holder in Due Course has all the rights given through and under the negotiable instrument. Additionally, the law gives these holders in due course special rights by protecting them from certain defenses. This protection makes negotiable instruments more attractive and allows greater ease of transfer.

Special Rights: To obtain the preferred status of a holder in due course, a person must first be a holder. The preferred status of Holder in Due Course also requires the additional standards set forth above. Unlike ordinary holders or assignees, holders in due course take free of contract assignment defenses, that are good against ordinary holders or assignees. Only universal defenses can pierce the status of a Holder in Due Course.

Defenses to Negotiable Instruments:

Defenses:

Defenses against Assignee or Ordinary Holder: Assignees of negotiable instruments are subject to every defense raised. Similarly, a holder who does not become a Holder in Due Course is also subject to every payment defense just as though the instrument were not negotiable.

Limited Defenses Available against a Holder but Not Against a Holder in Due Course: Holders in Due Course are not subject to any of the following defenses, but ordinary holders are:

Ordinary Contract Defenses: In general terms, the defenses that could be raised in a breach of contract claim cannot be raised against a Holder in Due Course. The defenses of lack, failure, or illegality of consideration with respect to the instrument's underlying transaction cannot be asserted against the Holder in Due Course. Misrepresentation about the goods underlying the contract is also not a defense.

Incapacity of Maker or Drawer: Ordinarily, the maker's or drawer's lack of capacity (except minors) may not be raised as a defense to payment to a holder in due course. Such incapacity is a defense, however, if the incapacity is at a legal level that makes the instrument a nullity.

Fraud in the Inducement: If a person is persuaded or induced to execute the instrument because of fraudulent statements, such **fraud in the inducement** cannot be raised against a party with Holder in Due Course status.

Miscellaneous Defenses: The limited defenses listed in the preceding three subsections are those most commonly raised against demands by Holders in Due Course for payment. The following are additional limited defenses that might be asserted: (1) prior payment or cancellation of the instrument, (2) non-delivery, (3) conditional or special-purpose delivery, (4) breach of warranty, (5) duress consisting of threats, (6) unauthorized completion, and (7) theft of a bearer instrument. Like the above, these miscellaneous defenses, however, also have a very limited effect in defending against a Holder in Due Course's demand for payment.

Universal Defenses against Holders in Due Course: Certain defenses are regarded as so basic that the social interest in preserving them outweighs the social interest of giving negotiable instruments their free transferable qualities. Accordingly, such defenses are given universal effect, and may be raised against all holders, assignees, and Holders in Due Course. These defenses are called **universal defenses.** Accordingly, such defenses are given universal effect and may be raised against all holders, including Holders in Due Course. These defenses include:

Fraud as to the Nature or Essential Terms of the Instrument: The fact that a person signs an instrument because the person is fraudulently deceived as to its nature or essential terms is a defense available against all holders.

Forgery or Lack of Authority: The defense that a signature was forged or signed without authority can be raised by a drawer or maker against any Holder in Due Course.

Duress Depriving Control: A party may execute or indorse a negotiable instrument in response to a force of such a nature that, under general principles of law, duress makes the transaction void rather than merely voidable. Duress is a universal defense.

Incapacity: The fact that the defendant is a minor who under general principles of contract law may avoid the obligation is a matter that may be raised against any kind of holder. Other kinds of incapacity may be raised as a defense if the effect of the incapacity is to make the instrument void, as when there has been a formal declaration of insanity.

Illegality: If an instrument is void by law when executed in connection with certain conduct, such as any act of illegality, such a defense may be raised against a Holder in Due Course.

Alteration: An alteration is an unauthorized change or completion of a negotiable instrument designed to modify the obligation of a party to the instrument. Alteration, like forgery, is a universal defense.

Checks and Fund Transfers:

Defined:

Check: Black's Law Dictionary defines a check to be **a draft signed by the maker or drawer, drawn on a bank, payable on demand, and unlimited in negotiability.** UCC Section 3-104: This section of law defines "Check" to mean "a draft … payable on demand and drawn on a bank or … a cashier's check or teller's check."

Fund Transfer: Black's Law Dictionary defines a fund transfer to be a sum of money or other liquid assets that are transferred from one party to another.

Electronic Fund Transfer: The Electronic Funds Transfer Act (EFTA) defines an electronic fund transfer to be any transfer of funds (other than a transaction originated by a check, draft, or similar paper instrument) that is initiated through an electronic terminal, a telephone, a computer, or a magnetic tape so as to authorize a financial institution to debit or credit an account.

Nature of a Check:

Generally: A check is a demand instrument which carries with it a presumption when made that sufficient funds are on deposit to pay the holder. It must be in writing and its delivery is not an assignment.

Certified Check:

Generally: A certified check is a check where the bank has, upon review of the check and the account from which it is drawn, set aside the amount of the check, and promises to pay such upon presentment.

Dishonor of a Check:

Generally: If the bank refuses to make payment, the drawer is then subject to the same secondary liability as the drawer of an ordinary draft. To be able to attach that secondary liability, the holder of the instrument must notify the drawer of the dishonor by the drawee. This notice of dishonor may be oral, written, or electronic.

Stopping Payment of a Check:

Generally: A drawer may stop payment of a check by notifying the drawee bank in the required manner. This is accomplished by means of a **stop payment order**, which is an order by a depositor to the bank to refuse to make payment of a check.

Fund Transfers:

Generally: Consumers are using electronic methods of payment at an increasing rate. From the swipe of the card at the grocery store checkout, to the retrieval of funds from the local automated teller machine, *electronic funds transfers* represent a way of life for many consumers. A combination of state and federal laws protect consumers making electronic funds transfers.

Electronic Funds Transfer Act: In 1978 Congress passed the Electronic Funds Transfer Act (EFTA) to protect consumers making electronic transfers of funds. Under this statute, Electronic funds transfer (EFT) means any transfer of funds (other than a transaction originated by check, draft, or similar paper instrument) that is initiated through an electronic terminal, a telephone, a computer, or a magnetic tape that authorizes a financial institution to debit or credit an account. The service available from an automated teller machine is a common form of EFT.

UCC Laws for Commercial Funds Transfers: Fund transfers made by commercial businesses are governed by the UCC and Federal Reserve regulations. In states that have adopted Article 4A of the Uniform Commercial Code, such article governs these commercial fund transfers. In addition, whenever a Federal Reserve Bank is involved, the provisions of Article 4A also apply by virtue of Federal Reserve regulations. The transfers regulated by Article 4A are characteristically made between highly sophisticated parties dealing with large sums of money. Speed of transfer is often an essential ingredient. An individual transfer may involve many millions of dollars, and the national total of such transfers on any business day can amount to trillions of dollars.