PART 4

Negotiable Instruments

27 Kinds of Instruments, Parties, and Negotiability

28 Transfers of Negotiable Instruments and Warranties of Parties

29 Liability of the Parties under Negotiable Instruments

30 Checks and Funds Transfers

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CHAPTER 27

Kinds of Instruments, Parties, and Negotiability

27-1 Types of Negotiable Instruments and Parties
- 27-1a Definition
- 27-1b Kinds of Instruments
- 27-1c Parties to Instruments

27-2 Negotiability
- 27-2a Definition of Negotiability
- 27-2b Requirements of Negotiability
- 27-2c Factors Not Affecting Negotiability
- 27-2d Ambiguous Language
- 27-2e Statute of Limitations

Learning Outcomes

After studying this chapter, you should be able to

LO.1 Explain the importance and function of negotiable instruments

LO.2 Name the parties to negotiable instruments

LO.3 Describe the concept of negotiability and distinguish it from assignability

LO.4 List the requirements for a negotiable instrument

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

27-1 Types of Negotiable Instruments and Parties

commercial paper–written, transferable, signed promise or order to pay a specified sum of money; a negotiable instrument.

For convenience and as a way to facilitate transactions, businesses began to accept certain kinds of paper called **commercial paper** or negotiable instruments as substitutes for money or as a means of offering credit.[1] Negotiable commercial paper is special paper created for the special purpose of facilitating transfer of funds and payment. In addition, the use of this special paper for special purposes can create additional rights in a special party status known as a *holder in due course*. Although the details on holders in due course are covered in Chapters 28 and 29, it is important to understand that one of the purposes of the use of special paper is to allow parties to achieve the special status of holder in due course and its protections and rights. Taking each component of negotiable instruments in step-by-step sequences, from their creation to the rights associated with each, and to their transfer, helps in understanding how commercial paper is used to create rights for special persons.

Article 3 of the Uniform Commercial Code (UCC) defines the types of negotiable instruments and the parties for each.[2] Article 3 of the UCC was last amended in 2002 with those reforms adopted in some states and under consideration in others.[3] Those changes are explained in each of the relevant sections.

27-1a Definition

negotiable instrument–drafts, promissory notes, checks, and certificates of deposit that, in proper form, give special rights as "negotiable commercial paper."

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…."[4] A *negotiable instrument* is a record of a signed promise or order to pay a specified sum of money.[5] The former requirement that the instrument be in writing to be valid has been changed to incorporate requirements of UETA (Uniform Electronic Transactions Act) and E-Sign (Electronic Signatures in Global and National Commerce Act of 2000). Many lenders now use electronic promissory notes.[6] In addition, we now have electronic checks, or those check withdrawals from your account that you authorize over the phone or via the Internet.

Instruments are negotiable when they contain certain elements required by the UCC. These elements are listed and explained in the section titled "Requirements of Negotiability" of this chapter. However, even those instruments that do not meet the requirements for negotiability may still be referred to by their UCC names or classifications.

CPA

27-1b Kinds of Instruments

There are two categories of negotiable instruments: (1) promises to pay, which include promissory notes and certificates of deposit,[7] and (2) orders to pay, including drafts and checks.

[1] *Carlucci v. Han*, 886 F. Supp. 2d 497 (E.D. Va. 2012).
[2] The law covering negotiable instruments has been evolving and changing. The earlier version was called UCC-Commercial Paper, and the 1990 version is called UCC-Negotiable Instruments.
[3] As of January 2015, 50 states, the District of Columbia, and the Virgin Islands had adopted the 2002 changes to Article 3.
[4] U.C.C. §3-104(a)(1) and (2).
[5] See U.C.C. §3-104.
[6] Electronic Signatures in Global and National Commerce Act, 15 U.S.C. §7001 (Supp. 2014).
[7] U.C.C. §3-104(j).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

FIGURE 27-1 Promissory Note

MARCH 31, 2015

Six months after date debtor undersigned hereby promises to pay to the order of Galactic Games, Inc., three thousand six hundred dollars with interest at the rate of 5.9%. This note is secured by the Video Arcade game purchased with its funds.

In the event of default, all sums due hereunder may be collected. Debtor agrees to pay all costs of collection including, but not limited to, attorney fees, costs of repossession, and costs of litigation.

/s/ JOHN R. HALDEHAND

VIDEO ARCADE, INC.

promissory note–unconditional promise in writing made by one person to another, signed by the maker engaging to pay on demand, or at a definite time, a sum certain in money to order or to bearer. (Parties—maker, payee)

certificate of deposit (CD)–promise-to-pay instrument issued by a bank.

draft, or bill of exchange–an unconditional order in writing 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 a sum certain in money to order or to bearer.

check–order by a depositor on a bank to pay a sum of money to a payee; a bill of exchange drawn on a bank and payable on demand.

cashier's check–draft drawn by a bank on itself.

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.[8] (See Figure 27-1)

Certificates of Deposit

A **certificate of deposit (CD)** is a promise to pay issued by a bank.[9] Through a CD, a bank acknowledges the customer's deposit of a specific sum of money and promises to pay the customer that amount plus interest when the certificate is surrendered.

Drafts

A **draft, or bill of exchange,** is an order by one party to pay a sum of money to a second party. (See Figure 27-2.) The party who gives the order is called the *drawer*, and the party on whom the order to pay is drawn is the *drawee*.[10] The party to whom payment is to be made is the *payee*. The drawer may also be named as the payee, as when a seller draws a draft naming a buyer as the drawee. The draft is then used as a means to obtain payment for goods delivered to that buyer. A drawee is not bound to pay a draft simply because the drawer has placed his name on it. However, the drawee may agree to pay the draft by accepting it, which then attaches the drawee's liability for payment.

Checks

Under U.C.C. §3-104(f), *check* means "a draft, other than a documentary draft, payable on demand and drawn on a bank."[11] A **check** 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).[12]

In addition to the ordinary checks just described, there are also cashier's checks, teller's checks, traveler's checks, and bank money orders. A **cashier's check** is a draft drawn by a bank on itself. U.C.C. §3-104(g) defines a cashier's check as "a draft with respect to which the drawer and drawee are the same bank or branches of the same bank."[13]

[8] *Heritage Bank v. Bruha*, 812 N.W.2d 260 (Neb. 2012).
[9] U.C.C. §3-104(j).
[10] U.C.C. §3-103(a)(2)–(3).
[11] U.C.C. §3-104(f).
[12] *Id.*
[13] U.C.C. §3-104(g).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

FIGURE 27-2 Draft

TO: Topa Fabrics, Inc. 1700 W. Lincoln Marina Del Rey, CA	March 17, 20 13
Thirty days from date	PAY TO THE ORDER OF
Malden Mills, Inc.	
THE SUM OF sixteen thousand and no/100	DOLLARS
ACCEPTED BY:	Aaron Johnson
	Malden Mills, Inc.
DATE	

teller's check–draft drawn by a bank on another bank in which it has an account.

traveler's check–check that is payable on demand provided it is countersigned by the person whose specimen signature appears on the check.

money order–draft issued by a bank or a nonbank.

party–person involved in a legal transaction; may be a natural person, an artificial person (e.g., a corporation), or an unincorporated enterprise (e.g., a governmental agency).

maker–party who writes or creates a promissory note.

drawer–person who writes out and creates a draft or bill of exchange, including a check.

drawee–person to whom the draft is addressed and who is ordered to pay the amount of money specified in the draft.

A **teller's check** is a draft drawn by a bank on another bank in which it has an account.[14] 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.[15] Money orders are issued by both banks and nonbanks. A **money order** drawn by a bank is also a check.[16]

CPA

27-1c Parties to Instruments

A note has two original parties: the *maker* and the *payee*.[17] A draft or a check has three original parties: the *drawer*, the *drawee*, and the *payee*. The names given to the parties to these instruments are important because the liability of the parties varies depending on the parties' roles. The rights and liabilities of the various parties to negotiable instruments are covered in Chapters 28 and 29.

A **party** to an instrument may be a natural person, an artificial person such as a corporation, or an unincorporated enterprise such as a government agency.

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.

[14] U.C.C. §3-104(h).
[15] U.C.C. §3-104(i).
[16] *Com. v. Pantalion*, 957 A.2d 1267 (Pa. Super. 2008). Some items are held to be checks for purposes other than Article 3 negotiability. For example, in In re *Armstrong* 291 F.2d 517 (8th Cir. 2002), the court held that gambling markers were checks for purposes of the state's "bad check" law.
[17] U.C.C. §3-103(a)(5).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Payee

payee–party to whom payment is to be made.

The **payee** is the person named in the instrument to receive payment. **For Example,** on a check with the words "Pay to the order of John Jones," the named person, John Jones, is the payee.

Acceptor

acceptor–drawee who has accepted the liability of paying the amount of money specified in a draft.

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.**[18]

Secondary Obligor (Accommodation Party)

accommodation party–person who signs an instrument to lend credit to another party to the paper.

When a party who is not originally named in an instrument allows her 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.[19] Revised Article 3 now refers to drawer, indorsers, and accommodation parties as "secondary obligors."[20]

27-2 Negotiability

negotiability–quality of an instrument that affords special rights and standing.

An instrument is a form of contract that, if negotiable, affords certain rights and protections for the parties. **Negotiability** is the characteristic that distinguishes commercial paper and instruments from ordinary contracts or what makes such paper and instruments[21] special paper. That an instrument is negotiable means that certain rights and protections may be available to the parties to the instrument under Article 3. A **nonnegotiable instrument's** terms are enforceable, but the instrument is treated simply as a contract governed by contract law.[22]

CPA

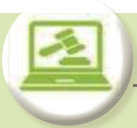
27-2a Definition of Negotiability

nonnegotiable instrument–contract, note, or draft that does not meet negotiability requirements of Article 3.

If an instrument is negotiable, it is governed by Article 3 of the UCC, and it may be transferred by negotiation. This 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. The process of negotiation is covered in Chapter 28. For more information on the rights of assignees of contracts, refer to Chapter 17.

[18] U.C.C. §3-103(a)(1).
[19] U.C.C. §3-419; In re *Rust*, 510 B.R. 562 (E.D. Ky. 2014).
[20] Revised Article 3, §3-103(12), has the following definition of a secondary obligor on an instrument "an indorser, a drawer, an accommodation party, or any other party to the instrument that has a right of recourse against another party to the instrument…." This definition was changed to be consistent with the Restatement of Surety.
[21] U.C.C. §3-104.
[22] Loan-and-supply contract is not a negotiable instrument. *Quality Oil, Inc. v. Kelley Partners, Inc.*, 657 F.2d 609 (7th Cir. 2011). A note payable when "lessee is granted possession of the premises" is not a negotiable instrument, but it is an enforceable contract. *Schiffer v. United Grocers, Inc.*, 989 P.2d 10 (Or. 1999). A deed of trust may or may not be a negotiable instrument. *Arnold v. Palmer*, 686 S.E.2d 725 (W. Va. 2009); In re *Smith*, 509 B.R. 260 (N.D. Cal. 2014).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203



E-COMMERCE & CYBERLAW

The Check Is in the Internet

The Check Clearing for the 21st Century Act ("Check 21") allows banks to use electronic images of checks as full and complete records of transactions, the same status formerly used only for paper checks that had been canceled. You can also pay your monthly credit card bills by preauthorizing your credit card company to withdraw the amount you specify from your account. With the bank's routing number and your account number, the company can obtain payment on the due date or any date you authorize. PayPal allows you to do the same with your bank account when you purchase items on the Internet. Paperless payment is on the increase.

CPA 27-2b Requirements of Negotiability

To be negotiable, an instrument (1) must be evidenced by a record and (2) must be signed (authenticated under Revised Article 3) by the maker or the drawer, (3) must contain an unconditional promise or order to pay, (4) must pay a sum certain, (5) must be payable in money, (6) must be payable on demand or at a definite time, and (7) must be payable to order or bearer, using what are known as words of negotiability.[23]

A Record (Writing)

A negotiable instrument must be evidenced by a record. The requirement of a *record*, under Revised Article 3, is satisfied by handwriting, typing, printing, electronic record, and any other method of making a record. A negotiable instrument may be partly printed and partly typewritten. No particular form is required for an instrument to satisfy the record requirement, although customers of banks may agree to use the banks' forms as part of their contractual agreement with their banks. Telephonic checks are a complete record for purposes of Article 3 rights and obligations.

Authenticated (Signed) by the Maker or Drawer

The instrument must be authenticated (signed under old Article 3) by the maker or the drawer. When a signature is used as authentication, it usually appears at the lower right-hand corner of the face of the instrument, but there is no requirement for where the signature must be placed on the instrument.[24]

The authentication may consist of the full name or of any symbol placed with the intent to authenticate the instrument. Other means of authentication that are valid as signatures include initials, figures, and marks. Electronic security devices can be used as a means of authentication for electronic records. A person signing a trade name or an assumed name is liable just as if the signer's own name had been used.

Agent. An authentication may be made by the drawer or the maker or by his or her authorized agent. **For Example,** Eileen Smith, the treasurer of Mills Company, could sign a note for her company as an agent. No particular form of authorization for an agent to authenticate an instrument is required. An authenticating agent should disclose on the instrument (1) the identity of the principal and (2) the fact that the authentication

[23] U.C.C. §3-104.

[24] According to Revised U.C.C. §3-103, *authenticate* means (a) to sign or (b) to execute or otherwise adopt a symbol, or encrypt or similarly process a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

was done in a representative capacity. When this information appears on the face of the instrument, an authorized agent is not liable on it.

The representative capacity of an officer of an organization can be shown by the authentication of the officer along with the title of the office and the organization's name.[25] **For Example,** a signature of "James Shelton, Treasurer, NorWest Utilities, Inc.," or "NorWest Utilities, Inc., by James Shelton, Treasurer," on a note is enough to show Shelton's representative capacity. NorWest Utilities, not Shelton, would be liable on the note.

representative capacity–action taken by one on behalf of another, as the act of a personal representative on behalf of a decedent's estate, or action taken both on one's behalf and on behalf of others, as a shareholder bringing a representative action.

Absence of Representative Capacity or Identification of Principal. If an instrument fails to show the **representative capacity** of the person who is authenticating or fails to identify the person, then the individual who authenticates the instrument is personally liable on the instrument to anyone who acquires superior rights, such as the rights of a holder in due course (see Chapter 29). Because the instrument is a final agreement, the parol evidence rule applies, and the party who authenticated is not permitted to introduce extrinsic evidence that might clarify his or her representative capacity. The party who authenticated, in order to avoid personal liability, must indicate on the face of the instrument his or her role in the principal, such as president or vice president. (For more information about the parol evidence rule, see Chapter 16.)

However, an agent is not personally liable on a check that is drawn on the bank account of the principal and authenticated by him or her, even though the agent failed to disclose his or her representative capacity on the check. **For Example,** a check that is already imprinted with the employer's name is not the check of the employee, regardless of whether the employee only authenticates with his or her name or also adds a title such as "Payroll Clerk" or "Treasurer" near the signature.

CASE SUMMARY

A Crushing Defeat on a Note That Had the Wrong Parties

FACTS: Green Valley Growers, Inc. (GVG) was a plant nursery owned by O. Wayne Massey and others. From 2001 until the GVG's bankruptcy, KC Crushed provided GVG raw materials and construction services, including the creation of ditches and irrigation ponds, building of rock roads, beds and loading docks, as well as the work on some of the greenhouses located on the property operated by GVG. GVG took out a loan and paid $396,527.10 of the proceeds to KC Crushed. On February 27, 2007, Massey and Hurley Ray Smith (owner of KC Crushed) executed a Promissory Note that stated: "I, Wayne Massey promise to repay Ray Smith for a Promissory Note in the amount of $400,000.00 with Interest."

Smith and Massey (defendants) contend that the Note "incorrectly listed Smith as the lender and Wayne Massey as the borrower." Smith stated that the Note was in fact between KC Crushed and GVG, not himself and Massey, "I did not draft or prepare the Promissory Note. I did not review the Promissory Note. When the Promissory Note was presented to me, I did not read it and simply signed the note as written ... I was signing on behalf of KC Crushed Concrete, not myself individually. Wayne Massey and I agreed that [GVG] would repay KC Crushed Concrete with periodic $5,000 loan repayments, as initial interest only payments." From April 2007 until December 2008, GVG paid Smith—not KC Crushed—$80,000 toward the Note, in $5,000 monthly installments.

Smith and KC Crushed moved for summary judgment that they are not liable to Randy Williams—the bankruptcy trustee for the GVG bankruptcy.

DECISION: The Note plainly stated that Massey was the borrower and Smith was the lender. But GVG wrote the $5,000 monthly checks to Smith, not to KC Crushed. Smith's argument that he did not read the Note before he signed is

[25] U.C.C. §3-402. In re *Bedrock Marketing, LLC*, 404 B.R. 939 (D. Utah 2009); *Free Green Can, LLC v. Green Recycling Enterprises*, LLC, Not Reported in F. Supp. 2d, 2011 WL 5130359 (N.D. Ill.), and *Arntz v. Valdez*, 2011 WL 3433018, 163 Wash. App. 1003 (Wash. App. 2011).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

A Crushing Defeat on a Note That Had the Wrong Parties continued

unavailing. Parties are presumed to know the contents of a document and have an obligation to protect themselves by reading documents prior to signing.

The parties' subjective beliefs cannot contradict the intent of the parties expressed within the four corners of the document. The rights and obligations of the parties "are determined solely from the written loan agreement, and any prior oral agreements between the parties are superseded by and merged into the loan agreement." The Note stated that the $400,000 debt ran from Massey to Smith, not from GVG to KC Crushed. The payments were not relevant because the document was clear. The payments could have been made for another purpose such as a capital contribution. [***Williams v. Houston Plants & Garden World, Inc.***, **508 B.R. 19 (S.D. Tex. 2014)]**

THINKING THINGS THROUGH

When Your John Hancock Is Enough

Work through the following examples of signatures on negotiable instruments and capacity, and determine whether there would be personal liability on the part of the company executives signing the instruments.

1. Donald Schaffer owned and operated Grafton Janitorial Service, Inc. On October 6, 1998, Mr. Schaffer obtained a $25,000 line of credit for his company from First Merit Bank by executing a promissory note, which he signed both as "Donald J. Schaffer, President" and "Donald J. Schaffer, Cosigner." The note contains no guarantee provision, and Mr. Schaffer did not sign the note in the capacity as a guarantor. **[*Schaffer v. First Merit Bank, N.A.*, 927 N.E.2d 15 (Ohio App. 2009)]**
2. A corporate guaranty was signed as follows:

THE PRODUCERS GROUP OF FLA., INC. a Florida corporation, by the following officers solely on behalf of the corporation:

/s/ Eddie Beverly, as its President

CORPORATE PRESIDENT Eddie Beverly

/s/ Stephen Edman, as its Secretary

CORPORATE SECRETARY Steve Edman

/s/ John Bauder, as its Treasurer

CORPORATE TREASURER John Bauder

Are the officers personally liable on the guaranty?

[*Tampa Bay Economic Development Corp. v. Edman*, 598 So. 2d 172 (Fla. App. 1992)]

Promise or Order to Pay

A promissory note must contain a promise to pay money. A mere acknowledgment of a debt, such as a record stating "I.O.U.," is not a promise. A draft or check must contain an order or command to pay money.

Unconditional Promise or Order

For an instrument to be negotiable, the promise or order to pay must be unconditional.[26] **For Example,** when an instrument makes the duty to pay dependent on the completion of the construction of a building, the promise is conditional and the instrument is nonnegotiable. The instrument is enforceable as a contract, but it is not a negotiable instrument given all the rights and protections afforded under Article 3.

An order for the payment of money out of a particular fund is negotiable. The instrument can refer to a particular account or merely indicate a source of reimbursement for the drawee, such as "Charge my expense account." Nor is an instrument conditional

[26] U.C.C. §3-109(c). *Stancik v. Hersch*, 2012 WL 1567213 (Ohio App. 2012). A mortgage is not a negotiable instrument because it is not a promise to pay; it is a lien. *Gardner v. Quicken Loans*, 567 Fed. Appx. 362 (6th Cir. 2014).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

when payment is to be made only from an identified fund if the issuer is a government or governmental unit or agency, or when payment is to be made from the assets of a partnership, an unincorporated association, a trust, or an estate.[27] However, the fund noted must in fact exist because payment from a fund to be created by a future event would be conditional. **For Example,** making an instrument "payable from the account I'll establish when the sale of my house occurs" is conditional because the fund's creation is tied to an event whose time of occurrence is unknown.

The standards for negotiability do not require that the issuer of the instrument be personally obligated pay it.[28] An instrument's negotiability is not destroyed by a reference to a related document. Section 3-106(b) provides, "A promise or order is not made conditional (i) by a reference to another writing for a statement of rights with respect to collateral, prepayment, or acceleration."[29] **For Example,** if a note includes the following phrase, "This note is secured by a mortgage on the property located at Hilding Lane," the note is still negotiable.[30]

Payment in Money

money–medium of exchange.

A negotiable instrument must be payable in money. **Money** is defined to include any medium of exchange adopted or authorized by the United States, a foreign government, or an intergovernmental organization. The parties to an instrument are free to decide which currency will be used for payment even though their transaction may occur in a different country.[31] **For Example,** two parties in the United States are free to agree that their note will be paid in pesos.

If the order or promise is not for money, the instrument is not negotiable. **For Example,** an instrument that requires the holder to take stock or goods in place of money is nonnegotiable. The instrument is enforceable as a contract, but it cannot qualify as a negotiable instrument for purposes of Article 3 rights.

Sum Certain

sum certain–amount due under an instrument that can be computed from its face with only reference to interest rates.

Negotiable instruments must include a statement of a **sum certain,** or an exact amount of money.[32] Without a definite statement as to how much is to be paid under the terms of the instrument, there is no way to determine how much the instrument is worth.

There are some minor variations from sum certain requirement. **For Example,** an instrument is not nonnegotiable because its interest rate provisions include changes in the rate at maturity or because it provides for certain costs and attorney fees to be recovered by the holder in the event of enforcement action or litigation.[33]

In most states, the sum payable under an instrument is certain even though it calls for the payment of a floating or variable interest rate. An instrument is negotiable even though it provides for an interest rate of 1 percent above the prime rate of a named bank. It is immaterial that the exact amount of interest that will be paid cannot be determined at the time the paper is issued because the rate may later change.[34]

[27] A check issued by a debtor in bankruptcy for payment of court-ordered obligations is not conditional because of the involvement of the court or ongoing conditions on the debtor's payments. *Ward v. Stanford*, 443 S.W.3d 334 (Tex. App. 2014).

[28] U.C.C. §3-110(c)(1)–(2) (1990); *Ocwen Loan Servicing, LLC v. Branaman*, 554 F. Supp. 2d 645 (N.D. Miss. 2008).

[29] U.C.C. §3-106(b).

[30] Reference to a bill of lading does not affect negotiability. *Regent Corp., U.S.A. v. Azmat Bangladesh, Ltd.*, 686 N.Y.S.2d 24 (1999). However, a reference to a standby agreement does affect negotiability. In re *Sabertooth, LLC*, 443 B.R. 671 (E.D. Pa. 2011).

[31] U.C.C. §3-107. *Means v. Clardy*, 735 S.W.2d 6 (Mo. App. 1987) (payment in cabinets makes a note nonnegotiable).

[32] *Heritage Bank v. Bruha*, 812 N.W.2d 260 (Neb. 2012).

[33] U.C.C. §3-106. In re *MCB Financial Group, Inc.*, 461 B.R. 914 (N.D. Ga. 2011).

[34] However, when too many documents are necessary to determine the interest rate and the interest rate floats, negotiability is affected. *Farouki v. Petra International Banking Corp.*, 63 F. Supp. 3d 84 (D.D.C. 2014).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CPA

Time of Payment

A negotiable instrument must be payable on demand or at a definite time.[35] If an instrument is payable "when convenient," it is nonnegotiable because the day of payment may never arrive. An instrument payable only upon the happening of a particular event that may or may not happen is not negotiable. **For Example,** a provision in a note to pay the sum certain when a person marries is not payable at a definite time because that particular event may never occur. It is immaterial whether the contingency in fact has happened because from an examination of the instrument alone, it still appears to be subject to a condition that might not occur.

Demand. An instrument is *payable on demand* when it expressly states that it is payable "on demand," at sight, or on presentation. U.C.C. §3-108(a) provides "A promise or order is 'payable on demand' if (i) it states that it is payable on demand or at sight, or otherwise indicates that it is payable at the will of the holder, or (ii) it does not state any time of payment."[36] Presentation occurs when a holder demands payment. Commercial paper is deemed to be payable on demand when no time for payment is stated in the instrument.[37]

definite time–time of payment computable from the face of the instrument.

Definite Time. The time of payment is a **definite time** if an exact time or times are specified or if the instrument is payable at a fixed time after sight or acceptance or at a time that is readily ascertainable.[38] The time of payment is definite even though the instrument provides for prepayment, for acceleration, or for extensions at the option of a party or automatically on the occurrence of a specified contingency.

CASE SUMMARY

Whenever... Paying When You Can Does Not a Negotiable Instrument Make

FACTS: Gary Vaughn signed a document stating that Fred and Martha Smith were loaning him $9,900. As to when the loan was to be repaid, the document stated, "when you can." Approximately 18 months later, the Smiths sued Vaughn for the entire amount, claiming default on the note as well as unjust enrichment. The Smiths moved for summary judgment. They contended that Vaughn was immediately liable for the entire amount but that they were willing to work out a repayment schedule. Vaughn also moved for summary judgment, arguing that he did not have to repay the Smiths because he did not have the ability to do so. The trial court denied the Smiths' motion and granted Vaughn's. The Smiths appealed.

DECISION: The court held the following: a promissory note that calls for a borrower to repay "when you can" was not payable on demand and was not a negotiable instrument. However, an issue of fact remained as to when a debt payable "when you can" became payable. There were other issues of fact, such as whether there was unjust enrichment and whether it was reasonable for the borrower to repay the debt. The language implied that there was an open-ended agreement. The parties might have a contract, but the Smiths could not demand payment as if the instrument were a demand negotiable instrument. Reversed for further factual determinations. **[*Smith v. Vaughn*, 882 N.E.2d 941 (Ohio App. 2007)]**

CPA

Missing Date. An instrument that is not dated is deemed dated on the day it is issued to the payee. Any holder may add the correct date to the instrument.

[35] U.C.C. §3-108.
[36] U.C.C. §3-108(a).
[37] U.C.C. §3-112; *Universal Premium Acceptance Corp. v. York Bank's Trust Co.*, 69 F.3d 695 (3d Cir. 1995); *State v. McWilliams*, 178 P.3d 121 (Mont. 2008).
[38] *Gallwitz v. Novel*, 2011 WL 303253 (Ohio App. 2011).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Effect of Date on a Demand Instrument. The date on a demand instrument controls the time of payment, and the paper is not due before its date. Consequently, a check that is postdated ceases to be demand paper and is not properly payable before the date on the check. A bank making earlier payment does not incur any liability for doing so unless the drawer has given the bank a postdated check notice.

payable to order–term stating that a negotiable instrument is payable to the order of any person described in it or to a person or order.

bearer–person in physical possession of commercial paper payable to bearer, a document of title directing delivery to bearer, or an investment security in bearer form.

Words of Negotiability: Payable to Order or Bearer

An instrument that is not a check must be **payable to order** or **bearer.**[39] This requirement is met by such phrases as "Pay to the order of John Jones," "Pay to John Jones or order," "Pay to bearer," and "Pay to John Jones or bearer." The use of the phrase "to the order of John Jones" or "to John Jones or order" shows that the person executing the instrument had no intention of restricting payment of the instrument to John Jones. These phrases indicate that there is no objection to paying anyone to whom John Jones orders the paper to be paid. Similarly, if the person executing the instrument originally wrote that it will be paid "to bearer" or "to John Jones or bearer," there is no restriction on the payment of the paper to the original payee. However, if the instrument is not a check and it is payable on its face "to John Jones," the instrument is not negotiable.[40] Whether an instrument is bearer or order paper is important because the two instruments are transferred in different ways and because the liability of the transferors can be different.

CASE SUMMARY

The Goal Was a Hockey Team AND a Negotiable Instrument

FACTS: William Kidd served as managing director of Limeco Corporation. In 2001, negotiations began between Kidd/Limeco (defendants) and R.W. Whitaker and Monty Fletcher (plaintiffs) in connection with what later became a failed effort to purchase a hockey team in Tupelo. Whitaker and Fletcher loaned Limeco $750,000. Whitaker and Fletcher claim that Kidd concealed the fact that Limeco had no assets. Whitaker also loaned Kidd an additional $100,000, with the understanding that Kidd and Limeco would be responsible for paying back the loan Whitaker had taken out from the Peoples Bank & Trust Company in Tupelo in order to make the loan to Kidd.

On July 1, 2002, the parties entered into what they referred to as promissory notes (referred to as the "Fletcher note" and the "Whitaker note") to memorialize the terms of the loan agreements they had made in early 2002. Both Fletcher and Whitaker were granted a continuing lien on Limeco's monies, securities, and/or other property for the entire amount of the promissory notes (each in the amount of $375,000).

On December 11, 2003, Whitaker and Fletcher filed separate complaints against Limeco and Kidd for recovery of the more than $850,000 that had never been repaid. The trial court found that, because the suit was brought after the contracts' statute of limitations had expired, it had to be dismissed. Whitaker and Fletcher argued that the notes were negotiable instruments and their fraud claim was valid because of the six-year statute of limitations that applied with regard to negotiable instruments.

DECISION: The court held that words of negotiability are an absolute requirement for a negotiable instrument. Without those words, the note is simply a contract, and a suit on a contract required that it be filed within three years. Because Whitaker and Fletcher were over the three years, their suit had to be dismissed. If they had had the words of negotiability, then the suit could have proceeded because it was brought well within the time limits. [***Whitaker v. Limeco Corp.*, 32 So. 3d 429 (Miss. 2010)**]

[39] Guaranteed student loans have too many restrictions on transfers to be negotiable instruments. *U.S. v. Carter*, 506 Fed. Appx. 853 (11th Cir. 2013).
[40] U.C.C. §3-108.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

ETHICS & THE LAW

Medicaid Eligibility and Article 3 Negotiability

Kenneth Wilson was hospitalized from January 7, 2007, until his death on February 22, 2007. During the hospitalization, Kenneth's wife, Doris, sold her 100 percent stock ownership in the Brothers Delivery Service (her husband's company) to her son. The agreement provided that Kenneth, Jr., would pay $62,531 in 60 installments of $1,041.82, starting March 1, 2007. Kenneth, Jr., did not sign the promissory note for these terms. Doris never signed the purchase agreement. Doris then applied for Medicaid benefits in order to cover the costs of her husband's hospitalization. Eligibility for Medicaid requires a determination that there are insufficient personal assets to pay the bill. The Division of Social Services concluded that Doris was the owner of a promissory note, a liquid asset, that could be sold to pay the medical bills. Coverage was denied due to excessive resources. Doris argues that there is no negotiable note because the requirements for negotiability are not met. The appellate court agreed because the underlying contract had not been signed by Doris and because there was not, as yet, a promissory note. The purchase agreement did not have words of negotiability and there was no definite time for payment because the note did not yet exist.

Discuss whether Doris attained Medicaid eligibility through a legal loophole. Does she actually have assets that could be used to pay at least part of the debt? Should legal definitions allow us to escape an obligation to pay?

[*Estate of Wilson v. Division of Social Services*, 685 S.E.2d 135 (N.C. App. 2009)]

order paper–instrument payable to the order of a party.

bearer paper–instrument with no payee, payable to cash or payable to bearer.

Order Paper. An instrument is payable to order, or **order paper,** when by its terms it is payable to the order of any person described in it ("Pay to the order of K. Read") or to a person or order ("Pay to K. Read or order").

Bearer Paper. An instrument is payable to bearer, or **bearer paper,** when it is payable (1) to bearer or the order of bearer, (2) to a specified person or bearer, or (3) to "cash," "the order of cash," or any other designation that does not purport to identify a person or when (4) the last or only indorsement is a blank indorsement (an indorsement that does not name the person to whom the instrument is negotiated). An instrument that does not identify any payee is payable to bearer.[41]

Whether an instrument is bearer or order paper is important for determining how the instrument is transferred (see Chapter 28) and what the liability of the parties under the instrument is. Review Figure 27-3 for more background.

CASE SUMMARY

I May Be a Thief, But under Article 3 Bearer Paper Rules, I Am Not a Forger

FACTS: Joshua Herrera found a purse in a dumpster near San Pedro and Kathryn Streets in Albuquerque. Herrera took the purse with him to a friend's house. Either Herrera or his friend called the owner of the purse and the owner retrieved the purse at some point. After the purse was returned to the owner, Herrera returned to the dumpster where he found a check and some other items. The check Herrera found was written out to "Cash" and he thought this meant that he "could get money for [the] check."

When he presented the check to the teller at a credit union to cash it, the teller instructed him to put his name on the payee line next to "Cash." Herrera added "to Joshua Herrera" next to the word "Cash" on the payee line of the check and indorsed the check.

Herrera had pleaded guilty to one count of forgery but moved to have the indictment dismissed on the grounds that adding his name to a bearer instrument was not forgery. He appealed the denial of the motion to dismiss the indictment.

[41] U.C.C. §3-104(d).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

I May Be a Thief, But under Article 3 Bearer Paper Rules, I Am Not a Forger continued

DECISION: The court held that the instrument that Herrera originally found was bearer paper. By adding his named "to Joshua Herrera" to the "Pay to" line after "Cash" did not change the character of the instrument from bearer to order paper. At best, the addition of the words created an ambiguity and under the code interpretations should continue to be treated as bearer paper. Since he did not alter the nature of the instrument or convert it to a different instrument, he could not be charged with forgery. [***New Mexico v. Herrera***, **18 P.3d 326 (N.M. App. 2000);** ***cert. den.*** **20 P.3d 810 (N.M. 2001)**]

FIGURE 27-3 Bearer versus Order Paper

"Pay to the order of ABC Corp."	ORDER
"Pay to the order of Bearer."	BEARER
"Pay to the order of ABC Corp. or Bearer"	BEARER
"Pay to the order of ABC Corp., Bearer"	ORDER
"Pay to the order of John Jones" (note)	ORDER
"Pay to the order of John Jones" (check)	ORDER
"Pay to John Jones" (note)	NONNEGOTIABLE
"Pay to John Jones" (check)	NEGOTIABLE/ORDER
"Pay to the order of John Jones or Bearer"	BEARER
"Pay to cash"	BEARER
"Pay to the order of cash"	BEARER

postdating–inserting or placing on an instrument a later date than the actual date on which it was executed.

collateral–property pledged by a borrower as security for a debt.

ambiguous–having more than one reasonable interpretation.

27-2c Factors Not Affecting Negotiability

Omitting a date of execution or antedating or **postdating** an instrument has no effect on its negotiability.

Provisions relating to **collateral,** such as specifying the collateral as security for the debt or a promise to maintain, protect, or give additional collateral, do not affect negotiability. **For Example,** the phrase "This note is secured by a first mortgage" does not affect negotiability.

27-2d Ambiguous Language

The following rules are applied when **ambiguous** language exists in words or descriptions:

1. Words control figures where conflict exists.
2. Handwriting supersedes conflicting typewritten and printed terms.
3. Typewritten terms supersede preprinted terms.
4. If there is a failure to provide for the payment of interest or if there is a provision for the payment of interest but no rate is mentioned, the judgment rate at the place of payment applies from the date of the instrument.[42]

27-2e Statute of Limitations

Article 3 of the UCC establishes a three-year statute of limitations for most actions involving negotiable instruments. This limitation also applies to actions for the conversion of such instruments and for breach of warranty. There is a six-year statute of limitations for suits on certificates of deposit and accepted drafts.

[42] In re *Blasco*, 352 B.R. 888 (N.D. Ala. 2006).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Make the Connection

Summary

An instrument or piece of commercial paper is a transferable, signed promise or order to pay a specified sum of money that is evidenced by a record. An instrument is negotiable when it contains the terms required by the UCC.

Negotiable instruments have two categories: (1) promises to pay and (2) orders to pay. Checks and drafts are orders to pay. Notes and certificates of deposits are promises to pay. In addition to ordinary checks, there are cashier's checks and teller's checks. A bank money order is a check even though it bears the words *money order*.

The original parties to a note are the maker and the payee. The original parties to a draft are the drawer, the drawee, and the payee. The term *party* may refer to a natural person or to an artificial person, such as a corporation. Indorsers and accommodation parties are considered secondary obligors.

The requirements of negotiability are that the instrument (1) be evidenced by a record, (2) be signed (authenticated) by the maker or the drawer, and (3) contain a promise or order (4) of an unconditional character (5) to pay in money (6) a sum certain (7) on demand or at a definite time (8) to order or bearer.

A check may be negotiable without being payable to order or bearer.

If an instrument meets the requirements of negotiability, the parties have the rights and protections of Article 3. If it does not meet the requirements of negotiability, the rights of the parties are governed under contract law.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

27-1 Types of Negotiable Instruments and Parties

LO.1 Explain the importance and function of negotiable instruments

See the discussion of negotiability that begins on page 521.

See the *New Mexico v. Herrera* case, pages 528–529.

LO.2 Name the parties to negotiable instruments

See the list of parties to instruments in the section titled "Parties to Instruments," pages 520–521.

27-2 Negotiability

LO.3 Describe the concept of negotiability and distinguish it from assignability

See *Whitaker v. Limeco Corp*. for what can happen if an instrument is not negotiable, page 527.

LO.4 List the requirements for a negotiable instrument

See the list of negotiability requirements, page 522.

See the *Williams v. Houston Plants & Garden World, Inc*. case to understand who is liable on negotiable instruments, pages 523–524.

See the *Smith v. Vaughn* case, page 526.

Key Terms

acceptor
accommodation party
ambiguous
bearer
bearer paper
cashier's check
certificate of deposit (CD)
check
collateral
commercial paper
definite time
draft, or bill of exchange
drawee
drawer
maker
money
money order
negotiability
negotiable instrument
nonnegotiable instrument
order paper
party
payable to order
payee
postdating
promissory note
representative capacity
sum certain
teller's check
traveler's check

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Questions and Case Problems

1. Harold H. Heidingsfelder signed a credit agreement as vice president of J. O. H. Construction Co. for a line of credit with Pelican Plumbing Co. The credit agreement contained the following language:

 In consideration of an open account privilege, I hereby understand and agree to the above terms.

 Should it become necessary to place this account for collection I shall personally obligate myself and my corporation, if any, to pay the entire amount due including service charges (as outlined above terms) thirty-three and one-third (33⅓%) attorney's fees, and all costs of collection, including court costs.

 Signed [Harold H. Heidingsfelder]
 Company J. O. H. Construction Co., Inc.

 When J. O. H. Construction failed to make payment, Pelican, claiming it was a holder of a negotiable instrument, sued Heidingsfelder to hold him personally liable for his failure to indicate a representative capacity on the credit agreement. He claims that a credit application is not a negotiable instrument and that he could not be held personally liable. Is he right? [*Pelican Plumbing Supply, Inc. v. J. O. H. Construction Co., Inc.*, 653 So. 2d 699 (La.)]

2. Abby Novel signed a note with the following on it: "Glen Gallwitz 1-8-2002 loaned me $5,000 at 6% interest a total of $10,000.00." The note did not contain a payment schedule or a time for repayment.

 Abby used the $10,000 as start-up money for her business and says that she orally agreed to repay the loan out of the proceeds from her first 1,000-product sales. Abby did not make any payments. Glen passed away and his son, as executor of his estate, demanded that Abby repay the $10,000 plus 6% interest for a total of $14,958 (the amount due as of April 2010). The trial court granted judgment for the estate. Abby has appealed, alleging that she repaid the note through the care she gave for Glen. The estate maintains that the instrument was a negotiable promissory note and that it is entitled to collect the amount due in cash. Who is correct and why? [*Gallwitz v. Novel*, 2011 WL 303253 (Ohio App.)]

3. Charter Bank of Gainesville had in its possession a note containing the following provision: "This note with interest is secured by a mortgage on real estate, of even date herewith, made by the maker hereof in favor of said payee.... The terms of said mortgage are by this reference made a part hereof." When the bank sued on the note, it said that it was a holder of a negotiable instrument. Is this instrument negotiable? [*Holly Hill Acres, Ltd. v. Charter Bank of Gainesville*, 314 So. 2d 209 (Fla. App.)]

4. On October 14, 1980, United American Bank of Knoxville made a $1,700,000 loan to Frederic B. Ingram. William F. Earthman, the president of the bank and a beneficiary of the loan, had arranged for the loan and prepared the loan documents. Mr. Ingram and Mr. Earthman were old friends, and Mr. Ingram had loaned Mr. Earthman money in the past. Mr. Ingram was in jail at the time of this loan and was unable to complete the documents for the loan. Mr. Earthman says that Mr. Ingram authorized him to do the loan so long as it did not cost him anything to do it.

 Also on October 14, 1980, Mr. Earthman prepared and executed a personal $1,700,000 note to Mr. Ingram, using a standard Commerce Union Bank note form. Mr. Earthman wrote "Frederic B. Ingram" in the space for identifying the lending bank and also filled in another blank stating that the note would be due "Eighteen Months after Date." With regard to the interest, Mr. Earthman checked a box signifying that the interest would be "At the Bank's 'Prime Rate' plus % per year."

 Mr. Earthman then sold both of the notes, which ended up in the hands of third parties (holders in due course) who demanded payment. Mr. Ingram raised the defense that he had not authorized Mr. Earthman to handle the transactions. The third parties said that the notes were negotiable instruments and that they were entitled to payment without listening to Mr. Ingram's defenses. Mr. Earthman said that his note to Mr. Ingram as well as the bank note from Mr. Ingram were not negotiable and that they could both raise defenses to the third parties seeking payment.

 Who is correct? What do you think of Mr. Earthman's banking processes and procedures? What ethical issues do you see in these loan transactions? [*Ingram v. Earthman*, 993 S.W.2d 611 (Tenn.)]

5. The state of Alaska was a tenant in a large office building owned by Univentures, a partnership. The state made a lease payment of $28,143.47 to Univentures with state treasury warrant No. 21045102. Charles LeViege, the managing partner of

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Univentures, assigned the warrant to Lee Garcia. A dispute then arose among the Univentures partners, and the company notified the state that it should no longer pay LeViege the rent. The state placed a stop payment order on the warrant. Garcia claimed that he was a holder of a negotiable instrument and that the state owed him the money. The state claimed that a warrant did not qualify as a negotiable instrument. The warrant was in writing, was signed by the governor of the state, provided a definite sum of $28,143.47, and stated that "it will be deemed paid unless redeemed within two years after the date of issue." The warrant stated that it was "payable to the order of Univentures." Does the warrant meet the requirements for a negotiable instrument? [*National Bank v. Univentures*, 824 P.2d 1377 (Alaska)]

6. NationWide Check Corp. sold money orders through local agents. A customer would purchase a money order by paying an agent the amount of the desired money order plus a fee. The customer would then sign the money order as the remitter or sender and would fill in the name of the person who was to receive the money following the printed words "Payable to." In a lawsuit between NationWide and Banks, a payee on some of these orders, the question was raised as to whether these money orders were checks and could be negotiable even though not payable to order or to bearer. Are the money orders negotiable instruments? [*NationWide Check Corp. v. Banks*, 260 A.2d 367 (D.C.)]
7. George S. Avery signed a letter regarding the unpaid balance on a $20,000 promissory note owed to Jim Whitworth in the form of a letter addressed to Whitworth stating: "This is your note for $45,000.00, secured individually and by our Company for your security, due February 7, 1984." The letter was signed: "Your friend, George S. Avery." It was typed on stationery with the name of Avery's employer, V & L Manufacturing Co., Inc., printed at the bottom and the words "George Avery, President" printed at the top. Avery says he is not personally liable on the note. The court granted summary judgment for Whitworth and Avery appealed. Who is liable? [*Avery v. Whitworth*, 414 S.E.2d 725 (Ga. App.)]
8. Northwest Harvest Products, Inc., fell behind on its trade account with Major Products Company, Inc., and Major requested a note for the debt. Northwest sent a $79,000 corporate note. The balance on the note was incorrect, and Northwest sent a second corporate note for $79,361.89. After further discussion between the parties, Major sent a $78,445.24 note. The Chief Executive Officer of Northwest at that time signed the note "Donald H. Eoll CEO," attached a Post-It brand fax transmittal memo indicating that the note came from Donald Eoll at Northwest, and sent the note via facsimile. The note went unpaid, and Major sued both Eoll and Northwest for the debt. Is the CEO personally liable on the note? What are the parol evidence factors in this case? [*Major Products Co., Inc. v. Northwest Harvest Products, Inc.*, 979 P.2d 905 (Wash. App. 1999)]
9. Atlas Capital, LLC's sole member and manager was Weston Wade Sleater. Mr. Sleater signed two promissory notes totaling $4,000,000 as the maker of the notes. The signature blocks of the notes read, "Weston Wade Sleater & Atlas Marketing Group, L.C," but the signature was only that of Mr. Sleater. Mr. Sleater is referred to as the maker of the note. Mr. Sleater failed to pay the notes and a bankruptcy trustee brought suit to collect the remaining amount due. Mr. Sleater maintains that the notes are not his but those of Atlas Capital. Is he correct? Is Mr. Sleater liable on the notes? Discuss the ambiguity issues as well as the way the notes were signed. [In re *Bedrock Marketing, LLC*, 404 B.R. 929 (D. Utah)]
10. Lloyd and Mario Spaulding entered into a contract to purchase property from Richard and Robert Krajcir. The two Spaulding brothers signed a promissory note to the Krajcir brothers with the following language: "The amount of $10,000 [is] to be paid sellers at the time of the initial closing [delivery of the deed]; plus, the principal amount payable to sellers at the time of the final indorsement of the subject H.U.D. loan." In litigation over the note, the Spauldings said it was not a negotiable instrument. The lower court found it to be a negotiable promissory note and the Spaulding partners appealed. Is the note negotiable? [*Krajcir v. Egid*, 712 N.E.2d 917 (Ill. App.)]
11. Is the following instrument negotiable?

> *I, Richard Bell, hereby promise to pay to the order of Lorry Motors Ten Thousand Dollars ($10,000) upon the receipt of the final distribution from the estate of my deceased aunt, Rita Dorn. This negotiable instrument is given by me as the down payment on my purchase of a 1986 Buick to be delivered in three weeks.*
>
> *Richard Bell (signature).*

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

12. Smith has in his possession the following instrument:

    September 1, 2003
    I, Selma Ray, hereby promise to pay Helen Savit One Thousand Dollars ($1,000) one year after date. This instrument was given for the purchase of Two Hundred (200) shares of Redding Mining Corporation, Interest 6%.
    Selma Ray (signature).

    What is this instrument? Is it negotiable?

13. Master Homecraft Co. received a promissory note with a stated face value from Sally and Tom Zimmerman. The note was payment for remodeling their home and contained unused blanks for installment payments but contained no maturity date. When Master Homecraft sued the Zimmermans on the note, the couple argued that they should not be liable on the note because it is impossible to determine from its face the amount due or the date of maturity. Decide. [*Master Homecraft Co. v. Zimmerman*, 22 A.2d 440 (Pa.)]

14. A note from Mark Johnson with HealthCo International as payee for $28,979.15 included the following language:

    [p]ayable in _________, Successive Monthly Installments of $ Each, and in 11 Successive Monthly Installments of $2,414.92 Each thereafter, and in a final payment of $2,415.03 thereafter. The first installment being payable on the ________ day of ______ 20 _____, and the remaining installments on the same date of each month thereafter until paid.

    Johnson signed the note. Is it negotiable? [*Barclays Bank, P.L.C. v. Johnson*, 499 S.E.2d 769 (N. C. App.)]

15. The text of a handwritten note stated simply that "'I Robert Harrison owe Peter Jacob $25,000 …,' /s/ Robert Harrison." Peter Jacob sought to use the handwritten note as a negotiable promissory note. Can he? [*Jacob v. Harrison*, 49 U.C.C. Rep. Serv. 2d 554 (Del. Super.)]

CPA Questions

1. A company has in its possession the following instrument:

$500.00 Dayton, Ohio
October 2, 1987

Sixty days after the date I promise to pay to the order of
Cash
Five Hundred Dollars
at Miami, Florida

Value received with interest at the rate of nine percent. This instrument is secured by a conditional sales contract.

No. 11 Due Dec. 1, 1987 Craig Burk
Craig Burk

This instrument is:

a. Not negotiable until December 1, 1987.
b. A negotiable bearer note.
c. A negotiable time draft.
d. A nonnegotiable note because it states that it is secured by a conditional sales contract.

2. The instrument shown here is a:

To: Middlesex National Bank
Nassau, N.Y.

September 15, 1994

Pay to the order of Robert Silver $4,000.00
Four Thousand and xx/100 Dollars
on October 1, 1994

Lynn Dexter
Lynn Dexter

a. Draft.
b. Postdated check.
c. Trade acceptance.
d. Promissory note.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

3. Under the commercial paper article of the UCC, for an instrument to be negotiable, it must:
   a. Be payable to order or to bearer.
   b. Be signed to the payee.
   c. Contain references to all agreements between the parties.
   d. Contain necessary conditions of payment.
4. An instrument reads as follows:

   $10,000 **Ludlow, Vermont**
   February 1, 1993

   I promise to pay to the order of Custer Corp. $10,000 within 10 days after the sale of my two-carat diamond ring. I pledge the sale proceeds to secure my obligation hereunder.

   R. Harris
   R. Harris

   Which of the following statements correctly describes this instrument?
   a. The instrument is nonnegotiable because it is not payable at a definite time.
   b. The instrument is nonnegotiable because it is secured by the proceeds of the sale of the ring.
   c. The instrument is a negotiable promissory note.
   d. The instrument is a negotiable sight draft payable on demand.
5. Which of the following instruments is subject to the provisions of the Negotiable Instruments Article of the UCC?
   a. A bill of lading
   b. A warehouse receipt
   c. A certificate of deposit
   d. An investment security
6. Under the Negotiable Instruments Article of the UCC, which of the following statements is correct regarding a check?
   a. A check is a promise to pay money.
   b. A check is an order to pay money.
   c. A check does not need to be payable on demand.
   d. A check does not need to be drawn on a bank.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Transfers of Negotiable Instruments and Warranties of Parties

28-1 Transfer of Negotiable Instruments
- 28-1a Effect of Transfer
- 28-1b Definition of Negotiation
- 28-1c How Negotiation Occurs: The Order or Bearer Character of an Instrument

28-2 How Negotiation Occurs: Bearer Instruments

28-3 How Negotiation Occurs: Order Instruments
- 28-3a Blank Indorsement
- 28-3b Special Indorsement
- 28-3c Qualified Indorsement
- 28-3d Restrictive Indorsement
- 28-3e Correction of Name by Indorsement
- 28-3f Bank Indorsement
- 28-3g Multiple Payees and Indorsements
- 28-3h Agent or Officer Indorsement
- 28-3i Missing Indorsement

28-4 Problems in Negotiation of Instruments
- 28-4a Forged and Unauthorized Indorsements
- 28-4b Quasi Forgeries: The Impostor Rule
- 28-4c Effect of Incapacity or Misconduct on Negotiation
- 28-4d Lost Instruments

28-5 Warranties in Negotiation
- 28-5a Warranties of Unqualified Indorser
- 28-5b Warranties of Other Parties

Learning Outcomes

After studying this chapter, you should be able to

LO.1 **Explain the difference between negotiation of order paper and negotiation of bearer paper**

LO.2 **List the types of indorsements and describe their uses**

LO.3 **Determine the legal effect of forged and unauthorized indorsements**

LO.4 **Be familiar with the forged payee impostor exceptions**

LO.5 **List the indorser's warranties and describe their significance**

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CPA 28-1 Transfer of Negotiable Instruments

Much of the commercial importance of negotiable instruments lies in the ease with which they can be transferred. Negotiable instruments are transferred by a process known as *negotiation*.

28-1a Effect of Transfer

When a contract is assigned, the transferee has the rights of the transferor. The transferee is entitled to enforce the contract but, as assignee, has no greater rights than the assignor. 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.

When a negotiable instrument is transferred by negotiation, the transferee becomes the *holder of the paper*. A holder who meets certain additional requirements may also be a **holder in due course.** The status of holder in due course gives immunity from certain defenses that might have been asserted against the transferor (see Chapter 29 for a discussion of the rights and role of a holder in due course).

holder in due course–a holder who has given value, taken in good faith without notice of dishonor, defenses, or that instrument is overdue, and who is afforded special rights or status.

28-1b Definition of Negotiation

Under U.C.C. §3-201(a), **negotiation** means "a transfer of possession … of an instrument by a person other than the issuer to a person who thereby becomes a holder."[1] Negotiation, then, is simply the transfer of a negotiable instrument in such a way that the transferee becomes a holder.[2] A **holder** is different from a possessor or an assignee of the paper. A holder is a transferee in possession of an instrument that runs to her. An instrument runs to a party if it is payable to her order, is indorsed to her, or is bearer paper.

negotiation–the transfer of commercial paper by indorsement and delivery by the person to whom it is then payable in the case of order paper and by physical transfer in the case of bearer paper.

holder–someone in possession of an instrument that runs to that person (i.e., is made payable to that person, is indorsed to that person, or is bearer paper).

28-1c How Negotiation Occurs: The Order or Bearer Character of an Instrument

The order or bearer character of the paper determines how it may be negotiated. The order or bearer character of an instrument is determined according to the words of negotiability used (see Chapter 27 for a complete discussion of order and bearer words of negotiation and more examples of bearer versus order instruments). The types of instruments that qualify as bearer paper include those payable to bearer as well as those payable to the order of "Cash" or payable in blank. The character of an instrument is determined as of the time negotiation takes place even though its character originally or at the time of prior transfers may have been different.

CPA 28-2 How Negotiation Occurs: Bearer Instruments

U.C.C. §3-201(b) provides, "If an instrument is payable to bearer, it may be negotiated by transfer of possession alone."[3] If an instrument qualifies for bearer status, then it is negotiated by **delivery** to another.[4] Delivery can be accomplished by actual transfer of

delivery–constructive or actual possession.

[1] U.C.C. §3-201(a).
[2] U.C.C. §3-201; *Bank of New York Mellon v. Deane*, 970 N.Y.S.2d 427 (N.Y. 2013); In re *Miller*, 666 F.3d 1255 (10th Cir. 2012).
[3] U.C.C. §3-201(b). In re *Hussain*, 508 B.R. 417 (9th Cir. 2014).
[4] If no payee is named, the instrument is bearer paper and is negotiated by delivery. *DCM Ltd. Partnership v. Wang*, 555 F. Supp. 2d 808 (E.D. Mich. 2008); *Waldron v. Delffs*, 988 S.W.2d 182 (Tenn. App. 1999).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

possession wherein the transferee has possession of the instrument, or constructive transfer, whereby the transferee has exclusive access. **For Example,** when mortgage lenders finance a home mortgage, they often transfer the underlying promissory note on the mortgage several times through financial streams. Many of the underlying problems in the financial market's collapse in 2008 were the large bundles of the promissory notes tied to home mortgages that were in amounts above the value of the mortgaged properties. Who held the bearer promissory notes became a critical issue in foreclosures. Bearer paper is negotiated to a person taking possession of it without regard to whether such possession is lawful. Because delivery of a bearer instrument is effective negotiation, it is possible for a thief or an embezzling officer to transfer title to a bearer instrument. Such a person's presence in the chain of transfer does not affect the rights of those who have taken the bearer instrument in good faith.[5]

CASE SUMMARY

The Blank Indorsement Draws a Blank on Wrongful Foreclosure

FACTS: On September 22, 2006, Richard and Sabrina Emmons signed an adjustable rate promissory note and deed of trust with Chevy Chase Bank (now known as Capital One) for a property located in Vancleave, Mississippi. The note indicates that "[t]he Lender or anyone who takes this Note by Transfer and who is entitled to receive payments under this Note is called the 'Note Holder.'" According to the terms of the deed of trust, "MERS (Mortgage Electronic Recording System) is the beneficiary under this Security Instrument." Based on the assignment of deed of trust, executed on April 9, 2010, MERS then assigned the Emmons' deed of trust to U.S. Bank as trustee.

The deed of trust listed MERS and MERS' successors and assigns as beneficiary and nominee. On April 9, 2010, MERS assigned the deed of trust to U.S. Bank. The Emmons defaulted on their payments. The deed of trust provides for a power of sale in the event of the borrowers' default—a right which U.S. Bank then exercised through a nonjudicial foreclosure (power of sale). The Emmons then filed suit alleging, among other things, wrongful foreclosure because they claimed U.S. Bank was not a holder of the promissory note.

DECISION: The court held that the Emmons' promissory note was a negotiable instrument that had been indorsed in blank and was therefore bearer paper. It could be further negotiated to a holder via the simple action of delivery. So the holder of the note (in this case, Capital One) would have the right to conduct a foreclosure sale should the parties fall into default on their payments. There was no wrongful foreclosure as long as the party foreclosing was a holder of the note and there had been a default. Capital One was a holder and the Emmons had defaulted. **[*Emmons v. Capital One*, 2012 WL 773288 (S.D. Miss. 2012)]**

Even though a bearer instrument may be negotiated by a mere transfer of possession, the one to whom the instrument is delivered may require the bearer to indorse the instrument. This situation most commonly arises when a check payable to "Cash" is presented to a bank for payment. The reason a transferee of bearer paper would want an indorsement is to obtain the protection of an indorser's warranties from the bearer.[6] The bank wants an indorsement on a check made payable to "Cash" so that it can turn to the party cashing the check in the event payment issues arise.

[5] U.C.C. §§3-202 and 3-204; *Knight Pub. Co., Inc. v. Chase Manhattan Bank, N.A.*, 479 S.E.2d 478 (N.C. App. 1997); review denied 487 S.E.2d 548 (N.C. 1997); In re *Federal-Nogul Global, Inc.*, 319 B.R. 363 (D. Del. 2005).

[6] The Uniform Electronic Transactions Act (UETA), promulgated by the National Conference of Commissioners on Uniform State Laws in July 1999 and enacted in 46 states, provides that the transfer of a note by electronic record affords the transferee the same rights as a tangible written note.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

ETHICS & THE LAW

Having Your Mortgage Set Aside

In cases such as the *Emmons v. Capital One* case, the borrowers bring suit seeking to have their mortgage obligations set aside on the basis of technicalities in the paperwork or the separation of the paperwork. Generally, these borrowers owe far more on their mortgages than their homes are worth. In some cases, the mortgages have been deemed invalid or the courts have held there was no authority for foreclosure because of the problems with note transfers and the right of foreclosure. Evaluate the ethics of the borrowers in seeking to have their mortgages set aside.

CPA 28-3 How Negotiation Occurs: Order Instruments

indorsement–signature of the payee on an instrument.

U.C.C. §3-201(b) provides, "if an instrument is payable to an identified person, negotiation requires transfer of possession of the instrument and its indorsement by the holder."[7] A negotiable instrument that is payable to the order of a specific party is *order paper*, which can be negotiated only through indorsement and transfer of possession of the paper. **Indorsement** and transfer of possession can be made by the payee or indorsee or by an authorized agent of that person.[8]

CASE SUMMARY

The Tax Man Cometh, but He Can't Provide Your Indorsement

FACTS: Thorton Ring was behind on his property taxes for his property in Freeport, Maine. When he received a check payable to his order from Advest, Inc., in the amount of $11,347.09, he wrote the following on the back of the check: "Payable to Town of Freeport Property Taxes 2 Main St."; he sent it along with a letter to the town offices. The letter included the following: "I have paid $11,347.09 of real estate taxes and request the appropriate action to redeem the corresponding property." Ring did nothing further and his property was then liened by the tax clerk. Ring objected because he had paid the taxes. The town argued that the check was not indorsed and Ring thus had not paid the taxes in time to avoid the lien. The lower court found for the town and Ring appealed.

DECISION: There was no indorsement. Ring's name must be signed for there to be negotiation of the instrument to the town. The check had only the first part of the necessary indorsement for order paper; Ring had to indorse the instrument for further negotiation. Indorsements vary according to the method of signing and the words used along with the signature. The nature of an indorsement also affects the future of the instrument in terms of its requirements for further negotiation. [***Town of Freeport v. Ring*, 727 A.2d 901 (Me. 1999)**]

28-3a Blank Indorsement

blank indorsement–an indorsement that does not name the person to whom the paper, document of title, or investment security is negotiated.

When the indorser merely signs a negotiable instrument, the indorsement is called a **blank indorsement** (Figure 28-1). A blank indorsement does not indicate the person to whom the instrument is to be paid, that is, the transferee. A blank indorsement turns an

[7] U.C.C. §3-201(b). Although the modern spelling is "endorsement," the UCC has retained the British spelling of "indorsement."

[8] UCC §3-204. The UCC spellings are "indorse" and "indorser," the spellings used in this text. However, courts (including in some cases in this text) use the modern "endorse" and "endorser." *Jenkins v. Wachovia Bank*, 711 S. E.2d 80 (Ga. App. 2011).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

FIGURE 28-1 Blank Indorsement

order instrument into a bearer instrument. A person who possesses an instrument on which the last indorsement is blank is the holder.[9] **For Example,** if a check is payable to the order of Jill Barnes and Ms. Barnes indorses the check on the back "Jill Barnes," then the check that was originally an order instrument is now a bearer instrument. The check can now be transferred as bearer paper, which requires only delivery of possession. Once Jill Barnes's signature appears as a blank indorsement on the back, the check becomes transferrable simply by delivery of possession to another party.

28-3b Special Indorsement

special indorsement–an indorsement that specifies the person to whom the instrument is indorsed.

indorsee–party to whom special indorsement is made.

A **special indorsement** consists of the signature of the indorser and words specifying the person to whom the indorser makes the instrument payable, that is, the **indorsee** (Figure 28-2).[10] **For Example,** if Jill Barnes wrote on the back of the check payable to her "Pay to Jack Barnes, /s/ Jill Barnes," the check could be negotiated further only through the signature and possession of Jack Barnes. A special indorsement in this case continues an order instrument as an order instrument. If, after receiving the check, Jack Barnes simply signed it on the back, the check would become bearer paper and could be transferred through possession only.

Although words of negotiability are required on the front of negotiable instruments, it is not necessary that indorsements contain the word *order* or *bearer*. Consequently, the

E-COMMERCE & CYBERLAW

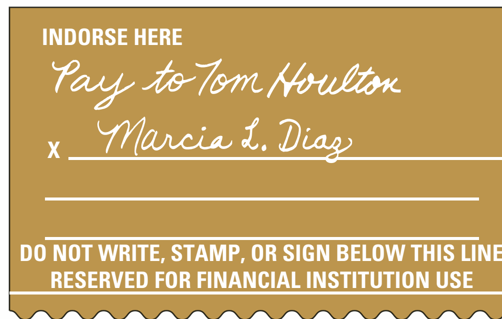
New Flexibility for Cyberspace Commercial Paper

The Check Clearing for the 21st Century Act (sometimes called "Check 21") allows banks to use images of checks as a substitute for paper checks. The substitute check is the legal equivalent of the paper check that has, for so long, dominated U.S. commerce. Under Check 21, the bank is also able to send you electronic copies of your canceled checks. Even if you still opt for paper summaries of your account activity each month, the bank need not return physical checks and can send small reproductions of your checks grouped together on the statement. Recently, you have been able to secure faster credits to your accounts for deposited checks because ATMs scan the checks in, checks that are recognized immediately as deposits. All the new regulations on check substitutes are known as Regulation CC and can be found at Regulation CC, 12 C.F.R. §229.2(zz)(2).

[9] In re *Smith*, 509 B.R. 260 (N.D. Cal. 2014).
[10] U.C.C. §3-205; *Chicago Title Ins. Co. v. Allfirst Bank*, 905 A.2d 366, 60 U.C.C. Rep. Serv. 2d 864 (Md. 2006).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

FIGURE 28-2 Special Indorsement



paper indorsed as shown in Figure 28-2 continues to be negotiable and may be negotiated further.[11]

An indorsement of "Pay to account [number]" is a special indorsement. In contrast, the inclusion of a notation indicating the debt to be paid is not a special indorsement.

28-3c Qualified Indorsement

qualified indorsement– an indorsement that includes words such as "without recourse" that disclaims certain liability of the indorser to a maker or a drawee.

A **qualified indorsement** is one that qualifies the effect of a blank or a special indorsement by disclaiming certain liability of the indorser to a maker or a drawee. This disclaimer is given by using the phrase "Without recourse" as part of the indorsement (Figure 28-3). Any other words that indicate an intent to limit the indorser's secondary liability in the event the maker or the drawee does not pay on the instrument can also be used.[12]

FIGURE 28-3 Qualified Indorsement

[11] Only a check may use the phrase "Pay to" on its face and remain negotiable. All other instruments require words of negotiability on their face. Indorsements, on all instruments, need only "Pay to." U.C.C. §3-110.

[12] *Antaeus Enterprises, Inc. v. SD-Barn Real Estate, LLC*, 480 F. Supp. 2d 734 (S.D.N.Y. 2007).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

The qualification of an indorsement does not affect the passage of title or the negotiable character of the instrument. It merely disclaims certain of the indorser's secondary liabilities for payment of the instrument in the event the original parties do not pay as the instrument provides.

This qualified form of indorsement is most commonly used when the indorser is a person who has no personal interest in the transaction. **For Example,** an agent or an attorney who is merely indorsing a check of a third person to a client might make a qualified indorsement because he is not actually a party to the transaction.

28-3d Restrictive Indorsement

restrictive indorsement– 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.

A **restrictive indorsement** specifies the purpose of the indorsement or the use to be made of the instrument (Figure 28-4).[13] An indorsement is restrictive when it includes words showing that the instrument is to be deposited (such as "For deposit only"), when it is negotiated for collection or to an agent or a trustee, or when the negotiation is conditional.[14]

A restrictive indorsement does not prevent transfer or negotiation of the instrument once the initial restriction is honored. The indorsement "For deposit only" requires only that the first party who receives the instrument after the restriction is placed on it comply with that restriction. The indorsement "For deposit only" makes an instrument a bearer instrument for any bank. If the indorser's account number is added to a "For deposit only" indorsement, then the only party who can take the instrument after this restrictive indorsement is a bank with that account number. A restrictive indorsement reduces the risk of theft or unauthorized transfer by eliminating the bearer quality of a blank indorsement.

28-3e Correction of Name by Indorsement

Sometimes the name of the payee or the indorsee of an instrument is spelled improperly. **For Example,** H. A. Price may receive a paycheck that is payable to the order of "H. O. Price." If this error in Price's name was a clerical one and the check is indeed intended for

FIGURE 28-4 Restrictive Indorsement

[13] U.C.C. §3-206.
[14] *Travelers Cas. and Sur. Co. of America v. Bank of America*, 2009 WL 5176769 (Sup. Ct. N.Y.).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

H. A. Price, the employee may ask the employer to write a new check payable to the proper name. However, under Article 3, a much simpler solution allows the payee or indorsee whose name is misspelled to indorse the wrong name, the correct name, or both. The person giving or paying value or taking it for collection for the instrument may require both forms of the signature.[15]

This correction of name by indorsement may be used only when it was intended that the instrument should be payable to the person making the corrective indorsement. If there were in fact two employees, one named H. A. Price and the other H. O. Price, it would be forgery for one to take the check intended for the other and, by indorsing it, obtain the benefit of the proceeds of the check.[16]

A fictitious, assumed, or trade name is treated the same as a wrong name. The same procedure for correction of a misspelled name with indorsement of both names applies to these forms of payee identification as well.[17]

28-3f Bank Indorsement

To simplify the transfer and collection of negotiable instruments from one bank to another, "any agreed method which identifies the transferor bank is sufficient for the item's further transfer to another bank."[18] A bank could simply indorse with its Federal Reserve System number instead of using its name.

Likewise, when a customer has deposited an instrument with a bank but has failed to indorse it, the bank may make an indorsement for the customer unless the instrument expressly requires the payee's personal indorsement. Furthermore, the mere stamping or marking on the item of any notation showing that it was deposited by the customer or credited to the customer's account is effective as an indorsement by the customer.

28-3g Multiple Payees and Indorsements

Ordinarily, one person is named as the payee in the instrument, but two or more payees may be named. In that case, the instrument may specify that it is payable to any one or more of them or that it is payable to all jointly. **For Example,** if the instrument is made payable "to the order of Ferns and Piercy," then Ferns and Piercy are joint payees. The indorsements of both Ferns and Piercy are required to negotiate the instrument.

alternative payees– those persons to whom a negotiable instrument is made payable, any one of whom may indorse and take delivery of it.

If the instrument is payable to **alternative payees** or if it has been negotiated to alternative indorsees, such as "Stahl or Glass" or "Stahl/Glass," it may be indorsed and delivered by either of them.

Under old Article 3, if the instrument was not clear on the relationship or types of multiple payees or indorsees, they were to be considered joint, and the signatures of all parties were required.[19] Under Revised Article 3, when a court is faced with two or more payees who are separated by a comma or other symbol, for example, "Pay to the order of Jeff Bridges–Susan Sarandon," the court must first determine whether the symbols or separating marks are sufficiently clear to make the instrument payable jointly. If the court concludes that the instrument is ambiguous, then the preference is for alternative payees, which means that either Jeff or Susan could negotiate the instrument with

[15] U.C.C. §3-204(d).
[16] *Hyatt Corp. v. Palm Beach Nat. Bank*, 840 So. 2d 300 (Fla. App. 2003).
[17] *DCM Ltd. Partnership v. Wang*, 555 F. Supp. 2d (E.D. Mich. 2008).
[18] U.C.C. §4-103.
[19] In re *Ames Dept. Stores, Inc.*, 322 B.R. 238 (S.D.N.Y. 2003).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

one signature; they would not have to have the other's indorsement for negotiation. Under Revised Article 3, if the instrument is ambiguous, the payees or indorsees are considered payees in the alternative.

CASE SUMMARY

Checking Indorsements at Check City

FACTS: L & T Enterprises issued checks to one of L & T's subcontractors and one of that subcontractor's suppliers. Check City cashed the checks but did so with the indorsement of only the subcontractor, not the supplier. The subcontractor had a long, positive history with Check City. Although the reverse side of the checks contained what at cursory glance might appear to be two signatures, even minimal attention to those signatures shows they are the subcontractor's business name and the signature of a presumably authorized employee, albeit in an order that is the opposite of what is customary. Both entries are in the same handwriting, and a prudent person cashing the checks could not possibly have mistaken the two entries for proper indorsements by both the subcontractor and the subcontractor's supplier.

Check City filed suit against L & T for negligence. The trial court held that L & T owed Check City a duty and that L & T breached that duty by failing to exercise ordinary care and substantially contributing to an alteration of an instrument or forged signature. L & T appealed.

DECISION: There is a difference between the liability for a forged indorsement and a missing indorsement. Here, Check City failed to obtain the necessary signatures for the two payees. The result is that Check City has liability for the losses. Check City cannot hold L & T liable for opening the door to forgery when it failed to ensure that the signatures were there and genuine, a duty it holds as the first party to receive the check. The judgment in favor of Check City on its complaint is reversed. The parties will bear their own costs on appeal. [***Check City, Inc. v. L & T Enterprises*, 237 P.3d 910 (Utah App. 2010)**]

28-3h Agent or Officer Indorsement

An instrument may be made payable to the order of an officeholder. **For Example,** a check may read "Pay to the order of Receiver of Taxes." Such a check may be received and negotiated by the person who at the time is the receiver of taxes. This general identification of a payee is a matter of convenience, and the drawer of the check is not required to find out the actual name of the receiver of taxes at that time.

If an instrument is drawn in favor of an officer of a named corporation, the instrument is payable to the corporation, the officer, or any successor to such officer. Any of these parties in possession of the instrument is the holder and may negotiate the instrument.[20]

28-3i Missing Indorsement

When the parties intend to negotiate an order instrument but for some reason the holder fails to indorse it, there is no negotiation. The transfer without indorsement has only the effect of a contract assignment.[21] If the transferee gave value for the instrument (see Chapter 29 for more information on what constitutes giving value), the transferee has the right to require that the transferor indorse the instrument unqualifiedly and thereby negotiate the instrument.

[20] U.C.C. §3-110(cc)(2)(li).
[21] U.C.C. §3-204(d). *Cyprus Federal Credit Union v. Cumis Ins. Soc., Inc.*, 2013 WL 7174130 (10th Cir. 2013).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

THINKING THINGS THROUGH

The Minor with an Embezzling Conservator

Steven Powell died in a tragic accident at work, entitling his minor son, Cody, to approximately $252,000 in life insurance proceeds. Karen Unrue, Steven's sister, approached Elizabeth Powell, Steven's widow, and offered to manage the insurance proceeds for Cody.

The probate court appointed Karen Unrue and Travis Powell (Steven's brother) as co-conservators. The probate court also waived the bond requirement and ordered "that the funds of the minor child, [Cody], be deposited in a restricted account and that no funds be withdrawn or transferred from such account without written [o]rder of [the probate court]." The certificate of appointment and fiduciary letter included the following restriction: "No withdrawals without court order."

On Cody's behalf, Unrue received seven checks totaling $252,447.51. Three of the checks were made payable to her and Travis jointly and included the designation "Co-conservators For [Cody], A Minor" or "Co-Cn For Minor, [Cody]." The other four checks were made payable to Unrue and included the designation "As Conservator Of [Cody], A Minor." Unrue endorsed the checks without including her title as co-conservator. Unbeknownst to Travis, Unrue forged his name on the three checks made payable to her and Travis as co-conservators and took all the checks to the Pawleys Island Bank of America (BOA). Unrue had Lee Ann Yourko, a personal banker, open a certificate of deposit (CD) account titled "Karen M. Unrue Guardian [Cody]." Yourko collected the checks and took them to a teller, who processed the checks and deposited the proceeds into the CD account. Neither Yourko nor the teller questioned the conservator designation in the payee line of the checks.

A few days later, Unrue returned to the Pawleys Island BOA with a single check for $253.67 made payable to her "As Conservator For Cody A Minor." Unrue requested Meredith Lawrence, the branch manager, to open a Uniform Gift to Minors Act (UGMA) account titled, "Karen M. Unrue—cust [Cody]—UMGA [sic]." Lawrence did not question the conservator title on the payee line of the check. Lawrence also failed to notice that Unrue endorsed the check without including her title.

Approximately a month later, after the CD matured, Unrue withdrew 100 percent of the funds, $253,991.50, from the CD account. Unrue took the funds to the Pawleys Island BOA and deposited them in the UGMA savings account. Over the next several months, Unrue made seven online transfers totaling $258,500 from the UGMA savings account to her personal checking account.

Mrs. Powell brought suit against BOA for its negligence in managing the accounts and failing to notice the indorsement requirements and restrictions imposed on the conservator.

Would Bank of America be liable? Be sure to discuss what you know about indorsement requirements and restrictive indorsements in formulating your answer.

[*Cody P. v. Bank of America, N.A.*, 720 S.E.2d 473 (S.C. App. 2011)]

CPA 28-4 Problems in Negotiation of Instruments

The issues of signatures and requirements for negotiation can become quite complex when issues such as forgery, employee misconduct, and embezzlement arise.

28-4a Forged and Unauthorized Indorsements

forged or unauthorized indorsement–instrument indorsed by an agent for a principal without authorization or authority.

A **forged** or **unauthorized indorsement** is not a valid indorsement.[22] Accordingly, anyone who has possession of a forged instrument is not a holder because the indorsement of the person whose signature was forged was necessary for effective negotiation of the instrument to the possessor. However, proof of forgery requires clear proof, and a split from a pattern of payments is helpful.

If payment of an instrument is made to one claiming under or through a forged indorsement, the payor ordinarily remains liable to the person who is the rightful owner of the paper. However, if the rightful owner has been negligent and contributed to the forgery or unauthorized signature problem, there are exceptions to these general rules on

[22] U.C.C. §3-403(2); Steven B. Dow, "Imposter Rule and the Problem of Agency under the Revised Uniform Commercial Code: New Risks for Bank Customers?" 16 *Comm. L.J.* 199 (2001).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

liability for forged indorsements (see Chapter 29 for more information on the rights and liabilities of the parties).

CASE SUMMARY

The Great Rite-Aid Heist

FACTS: B.D.G.S., Inc., a New York corporation with headquarters in Washington, owns a warehouse in Utica, New York. In 1991, B.D.G.S. entered into an oral agreement with two local men, Anthony Balio and his employee, Peter Duniec, to manage the warehouse. Their responsibilities included finding tenants and collecting rent, which was then to be forwarded to B.D.G.S. and deposited into its bank account in Washington. Balio and Duniec formed the Beechgrove Warehouse Corporation and maintained a business account in that name at Savings Bank of Utica (SBU).

Between 1996 and 2000, B.D.G.S. believed that one of its tenants, Rite-Aid, had been falling behind and failing to make its rent payments. B.D.G.S. later discovered that Rite-Aid had been making the payments, but 16 checks had been indorsed to Beechgrove Warehouse and deposited into Beechgrove's SBU account. The checks had been made payable to DBGS (an apparent typographical error). There was a handwritten indorsement on the back of each check stating:

DBGS, Inc.
Pay to the order of
Beechgrove Warehouse
For Deposit [followed by Beechgrove's SBU account number]

A refund check from Niagara Mohawk for $427,781.82 had similarly been indorsed and deposited in the SBU account. B.D.G.S. filed suit against SBU, Balio, Duniec, and Beechgrove Warehouse. B.D.G.S. also brought a claim against SBU. The jury found that SBU had not followed reasonable commercial standards by accepting the checks for deposit. The appellate court affirmed and SBU appealed.

DECISION: The court affirmed noting that SBU was dealing with a payee forgery and it was SBU's responsibility to verify that the party with the checks was actually the payee and was authorized to deposit the checks. Because SBU was the one that had contact with Balio and Duniec it had a chance to prevent the embezzlement but its practices were not detailed enough to catch payee forgeries. [***B.D.G.S., Inc. v. Balio*, 861 N.E.2d 813 (N.Y. 2006)**]

28-4b Quasi Forgeries: The Impostor Rule

impostor rule–an exception to the rules on liability for forgery that covers situations such as the embezzling payroll clerk.

The **impostor rule** provides three exceptions to the rule that a forged indorsement is not effective to validly negotiate an instrument. If one of the three impostor exceptions applies, the instrument is still effectively negotiated, even though there may have been a forgery of an indorsement.

When the Impostor Rule Applies

The impostor rule applies in cases where an indorser is impersonating a payee and in two cases where the indorser is a dummy payee.[23]

Impersonating Payee. The impersonation of a payee in the impostor rule exception includes impersonation of the agent of the person who is named as payee. **For Example,** if Jones pretends to be the agent of Brown Corporation and thereby obtains a check payable to the order of the corporation, the impostor exception applies.

Dummy Payee. Another impostor scenario arises when the preparer of the instrument intends that the named payee will never benefit from the instrument. Such a "dummy" payee may be an actual or a fictitious person. This situation arises when the owner of a checking account wishes to conceal the true purpose of taking money from the account at

[23] *State Sec. Check Cashing, Inc. v. American General Financial Services (DE),* 972 A.2d 882 (Md. 2009).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

the bank. The account owner makes out a check purportedly in payment of a debt that in fact does not exist.[24]

Dummy Payee Supplied by Employee. The third impostor situation arises when an agent or employee of the maker or the drawer has supplied the name to be used for the payee, intending that the payee should not have any interest in the paper.[25] This last situation occurs when an employee fraudulently causes an employer to sign a check made to a customer or another person, whether existing or not. The employee does not intend to send it to that person but rather intends to forge the latter's indorsement, cash the check, and keep the money. This exception to the impostor rule imposes responsibility on employers to have adequate internal controls to prevent employees from taking advantage of an accounting system with loopholes so that others are not required to bear the cost of the employer's lack of appropriate precautions.

Effect of Impostor Rule

When the impostor rule is applicable, any person may indorse the name of the payee. This indorsement is treated as a genuine indorsement by the payee and cannot be attacked on the ground that it is a forgery. This recognition of the fictitious payee's signature as valid applies even though the dummy payee of the paper is a fictitious person.[26]

Limitations on Impostor Rule

The impostor rule does not apply when there is a valid check to an actual creditor for a correct amount owed by the drawer and someone later forges the payee's name. The impostor rule does not apply in this situation even if the forger is an employee of the drawer.

Even when the unauthorized indorsement of the payee's name is effective by virtue of the impostor rule, a person forging the payee's name is subject to civil and criminal liability for making such an indorsement.

For the impostor rule to apply, the holders or the takers of the instrument must show that they took the instrument (1) in good faith and (2) for payment or collection.

CASE SUMMARY

Sorry, Charlie Walks Away with the $6.3 Million

FACTS: Won Charlie Yi solicited money from investors in the Korean–American community (plaintiffs) by representing that he would invest their money in brokerage accounts at Carlin Equities Corporation, a nationally recognized broker-dealer based in New York. Yi, however, did not invest the money he received from plaintiffs at all. Instead, Yi registered the name "Carlin Co." as a fictitious name under which he did business. He opened a bank account at Wells Fargo in the name of "Won Charlie Yi dba Carlin Co." Between January and September of 2003, Yi received eight checks, totaling $6.3 million, payable to "Carlin Co.," "Carlin Corp.," or "Carlin Corporation." Yi deposited the checks into his Wells Fargo account and absconded with plaintiffs' money. He was later apprehended by federal authorities and convicted of a variety of criminal fraud charges.

The defrauded investors filed suit against Wells Fargo to recover their losses for the bank's lack of ordinary care in

[24] *Schultz v. Bank of America*, 990 A.2d 1078 (Md. 2010).
[25] *Advocate Health and Hospitals Corp. v. Bank One*, 810 N.E.2d 962 (Ill. App. 2004).
[26] *Bank of Nichols Hills v. Bank of Oklahoma*, 196 P.3d 984 (Okla. App. 2008). *Advance Dental Care, Inc. v. SunTrust Bank*, 816 F. Supp. 2d 268 (D. Md. 2011); *State Sec. Check Cashing, Inc. v. American General Financial Services*, 972 A.2d 882 (Md. 2009).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Sorry, Charlie Walks Away with the $6.3 Million continued

being certain that the checks deposited were deposited with the intended payee. A jury found in favor of Wells Fargo and the investors appealed.

DECISION: The court affirmed the lower court's decision because the checks were made out to an intended payee. Although there were differing names on the check and the indorsements were not always precise, the parties intended the checks to go to Charlie's company and Charlie's account. Charlie was a fraudster and they lost their money, but Wells Fargo is not liable for losses when customers write legitimate checks to those whom they later realize cannot be trusted. Losses are absorbed by banks when they fail to act in a commercially reasonable manner in honoring checks. In this situation, there were no signals that there was anything wrong with the checks because, indeed, the checks were written by the account holders. [***Unlimited Adjusting Group Inc. v. Wells Fargo Bank*, 94 Cal. Rptr. 3d. 672 (2009)**]

Negligence of Drawee not Required

The impostor rule applies without regard to whether the drawee bank acted with reasonable care.

28-4c Effect of Incapacity or Misconduct on Negotiation

A negotiation is effective even though (1) it was made by a minor or any other person lacking capacity; (2) it was an act beyond the powers of a corporation; (3) it was obtained by fraud, duress, or a mistake of any kind; or (4) the negotiation was part of an illegal transaction or was made in breach of duty. The rights of the parties in these types of negotiations depends on who holds the instrument (see Chapter 29).

28-4d Lost Instruments

The liability on lost instruments depends on who is demanding payment from whom and on whether the instrument was order or bearer paper when it was lost.

Order Instruments

If the lost instrument is order paper, the finder does not become the holder because the instrument has not been indorsed and delivered by the person to whom it was then payable. The former holder who lost it is still the rightful owner of the instrument.

Bearer Instruments

If the lost instrument is in bearer form when it is lost, the finder, as the possessor of a bearer instrument, is the holder and is entitled to enforce payment.

CPA 28-5 Warranties in Negotiation

When a negotiable instrument is transferred by negotiation, the transferors give certain implied warranties.

28-5a Warranties of Unqualified Indorser

When the transferor receives consideration for the indorsement and makes an unqualified indorsement, the warranties stated in this section are given by the transferor by implication.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

No distinction is made between an unqualified blank indorsement and an unqualified special indorsement.

Scope of Warranties

The warranties of the unqualified indorser are found in Section 3-416 of the UCC and provide that the warrantor is a person entitled to enforce the instrument; that all signatures on the instrument are authentic and authorized; that the instrument has not been altered; that the instrument is not subject to a defense or claim; that the drawer of the draft has authorized the issuance of the item in the amount for which the item is drawn; and that the warrantor has no knowledge of any insolvency proceeding with respect to the maker or acceptor.[27]

Those who present an instrument for payment (see Chapter 29), or the last party in line before the payor, make three warranties: that the warrantor is entitled to enforce the draft or authorized to obtain payment or acceptance of the draft; that the draft has not been altered; and that the warrantor has no knowledge that the signature of the drawer of the draft is unauthorized.[28]

If a forged indorsement has appeared during the transfer of the instrument, and there is a refusal to pay because of that problem, the last party who is a holder may turn to her transferor to recover on the basis of these implied warranties. These warranties give those who have transferred and held the instrument recourse against those parties who were involved in the transfer of the instrument, although they were not parties to the original instrument.

What Is Not Warranted

The implied warranties stated here do not guarantee that payment of the instrument will be made. Similarly, the holder's indorsement of a check does not give any warranty that the account of the drawer in the drawee bank contains funds sufficient to cover the check. However, implied warranties do, for example, promise that the signatures on the instrument are not forged. Likewise, they promise that no one has altered the amount on the instrument. The warranties are not warranties of payment or solvency. They are simply warranties about the nature of the instrument. A holder may not be paid the amount due on the instrument, but if the lack of payment results from a forgery, the holder has rights against those who transferred the instrument with a forged signature.

Beneficiary of Implied Warranties

The implied warranties of the unqualified indorser pass to the transferee and any subsequent transferees. There is no requirement that subsequent transferees take the instrument in good faith to be entitled to the warranties. Likewise, the transferee need not be a holder to enjoy warranty protections.

Disclaimer of Warranties

Warranties may be disclaimed when the instrument is not a check. A disclaimer of warranties is ordinarily made by adding "Without warranties" to the indorsement.

Notice of Breach of Warranty

To enforce an implied warranty of an indorser, the party claiming under the warranty must give the indorser notice of the breach. This notice must be given within 30 days

[27] U.C.C. §3-416 (1990).
[28] U.C.C. §3-417. These warranties are for consumer accounts.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

after the claimant learns or has reason to know of the breach and the identity of the indorser. If proper notice is not given, the warranty claim is reduced by the amount of the loss that could have been avoided had timely notice been given.

28-5b Warranties of Other Parties

Warranties are also made by the indorser who indorses "Without recourse" and by one who transfers by delivery only.

Qualified Indorser

The warranty liability of a qualified indorser is the same as that of an unqualified indorser.[29] A qualified indorsement means that the indorser does not assume liability for the payment of the instrument as written. (See §3-416(4).) However, a qualified indorsement does not eliminate the implied warranties an indorser makes as a transferor of an instrument. The implied warranty that is waived by a qualified indorsement is the fourth warranty on defenses. A qualified indorser still makes the other warranties on signatures and alteration but waives the warranty on defenses.

Transfer by Delivery

When the negotiable instrument is negotiated by delivery without indorsement, the warranty liability of the transferor runs only to the immediate transferee. In all other respects, the warranty liability is the same as in the case of the unqualified indorser. **For Example,** Thomas, a minor, gives Craig his note payable to bearer. Craig transfers the note for value and by delivery only to Walsh, who negotiates it to Hall. Payment is then refused by Thomas, who chooses to disaffirm his contract. Hall cannot hold Craig liable. Craig, having negotiated the instrument by delivery only, is liable on his implied warranties only to his immediate transferee, Walsh. Likewise, because Craig did not indorse the note, he is not secondarily liable for payment of the note.

Make the Connection

Summary

Negotiation is the transferring of a negotiable instrument in such a way as to make the transferee the holder. When a negotiable instrument is transferred by negotiation, the transferee becomes the holder of the instrument. If such a holder becomes a holder in due course, the holder will be immune to certain defenses.

An *order instrument* is negotiated by an indorsement and delivery by the person to whom it is then payable. A bearer instrument is negotiated by delivery alone. The order or bearer character of an instrument is determined by the face of the instrument as long as the instrument is not indorsed. If the instrument has been indorsed, the character is determined by the last indorsement.

A number of different kinds of indorsements can be made on negotiable instruments. When an indorser merely authenticates the instrument, the indorsement is called a *blank indorsement*. If the last indorsement is a blank indorsement, the instrument is bearer paper, which may be negotiated by change of possession alone. A special indorsement consists of the authentication by the indorser and words specifying the person to whom the indorser makes the instrument payable. If the last

[29] U.C.C. §3-416(a).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

indorsement is a special indorsement, the instrument is order paper and may be negotiated only by an indorsement and delivery. A qualified indorsement eliminates the liability of the indorser to answer for dishonor of the paper by the maker or the drawee. A restrictive indorsement specifies the purpose of the instrument or its use.

A forged or unauthorized indorsement is no indorsement, and the possessor of the instrument cannot be a holder. The impostor rule makes three exceptions to this rule: dummy payee; employee fraud; and impersonating a payee.

A negotiation is effective even though (1) it is made by a minor, (2) it is an act beyond the powers of a corporation, (3) it is obtained by fraud, or (4) the negotiation is part of an illegal transaction. However, the transferor may be able to set aside the negotiation under general legal principles apart from the UCC. The negotiation cannot be set aside if the instrument is held by a person paying it in good faith and without knowledge of the facts on which the rescission claim is based.

The warranties of the unqualified indorser are as follows: (1) the warrantor is a person entitled to enforce the instrument; (2) all signatures on the instrument are authentic and authorized; (3) the instrument has not been altered; (4) the instrument is not subject to a defense or claim in recoupment of any party that can be asserted against the warrantor; with respect to any item drawn on a consumer account, which does not bear a handwritten signature purporting to be the signature of the drawer, that the purported drawer of the draft has authorized the issuance of the item in the amount for which the item is drawn; and (5) the warrantor has no knowledge of any insolvency proceeding commenced with respect to the maker or acceptor or, in the case of an unaccepted draft, the drawer.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

28-1 Transfer of Negotiable Instruments

28-2 How Negotiation Occurs: Bearer Instruments

28-3 How Negotiation Occurs: Order Instruments

LO.1 Explain the difference between negotiation of order paper and negotiation of bearer paper

See the *Emmons v. Capital One* case, page 537.

See the Ethics & the Law issue "Having Your Mortgage Set Aside" to see that the note is separate from the mortgage, page 538.

LO.2 List the types of indorsements and describe their uses

See the *Town of Freeport v. Ring* case, page 538.

See *Check City, Inc. v. L & T Enterprises* for joint payee issues, page 543.

28-4 Problems in Negotiation of Instruments

LO.3 Determine the legal effect of forged and unauthorized indorsements

See the Thinking Things Through feature on minors affected by conservators misusing funds placed in trust with them, page 544.

LO.4 Be familiar with the forged payee impostor exceptions

See the *B.D.G.S., Inc. v. Balio* case, page 545.

See the *Unlimited Adjusting Group, Inc. v. Wells Fargo Bank* case, pages 546–547.

28-5 Warranties in Negotiation

LO.5 List the indorser's warranties and describe their significance

See the discussion of warranties, pages 547–549.

Key Terms

alternative payees
blank indorsement
delivery
forged or unauthorized indorsement
holder
holder in due course
impostor rule
indorsee
indorsement
negotiation
qualified indorsement
restrictive indorsement
special indorsement

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Questions and Case Problems

1. Corey Brandon Bumgarner, who was separated from his wife, Crystal, had an accident caused by Donald Wood that resulted in $2,164.46 in damages to Corey's vehicle. Wood's insurance carrier mailed a draft in the amount of $2,164.46 drawn on Fleet Bank of Hartford, Connecticut, payable to Corey, to his box at P.O. Box 153, Hillsboro, North Carolina. The draft was negotiated at Community Bank and Trust, and the name, "Crystal Bumgarner," was handwritten on the back of the draft. Corey's name was written below Crystal Bumgarner's name. Crystal Bumgarner's driver's license number was handwritten on the front of the draft.

   Corey Bumgarner filed suit to have the insurer pay him the $2,164.46. The insurer indicated that it had sent order paper, that it had been delivered, and that there was, therefore, no claim against it or Wood. The trial court found that there had been no delivery and that Bumgarner was entitled to another check. Wood and his insurer appealed. Who is correct about delivery and why? [*Bumgarner v. Wood*, 563 S.E.2d 309, 47 U.C.C. Rep. Serv. 2d 1099 (N.C. App.)]

2. How could a check made out to "Joseph Klimas and his Attorney Fritzshall & Gleason & Blue Cross Blue Shield Company and Carpenters Welfare Fund" be negotiated further? What would be required? [*Chicago District Council of Carpenters Welfare Fund v. Gleason & Fritzshall*, 693 N.E.2d 412 (Ill. App.)]

3. An insurer issued a settlement check on a claim brought by an injured minor that was payable to "Trudy Avants attorney for minor child Joseph Walton, mother Dolores Carpenter 11762 S. Harrells Ferry Road #E Baton Rouge LA 70816." The lawyer indorsed the check. Two unknown individuals forged indorsements for the other two names and obtained payment of the check. The insurer sued the payor bank claiming that the instruments were not properly payable because of the forged indorsements. The court is unclear whether the indorsement required is one for an either/or payee or joint payee. What advice can you offer the court as it faces this issue? [*Coregis Insurance Co. v. Fleet National Bank*, 793 A.2d 254 (Conn. App.)]

4. ABCO (Abbott Development Company) made a note payable to Western State Bank of Midland. The FDIC took over Western State's operations after it failed. ABCO had defaulted on the note, after which the FDIC permitted ABCO Homes to refinance the note, making its refinancing note payable to the FDIC. The FDIC indorsed its note to SMS Financial and inadvertently sent it to SMS as part of a large batch of documents. When litigation resulted on the note, SMS claimed it was the holder. Others challenged its status, saying that SMS never had the instrument delivered to it. The lower court held SMS was not a holder and SMS appealed. Is SMS a holder? Why or why not? [*SMS Financial, L.L.C v. ABCO Homes, Inc.*, 167 F.3d 235 (5th Cir.)]

5. Jerry O. Peavy, Jr., who did not have a bank account of his own, received a draft from CNL Insurance America in the amount of $5,323.60. The draft was drawn on CNL's account at Bank South, N.A., and was "payable to the order of Jerry Peavy and Trust Company Bank." Jerry O. Peavy, Sr., allowed his son Peavy, Jr., to deposit the draft in his account at Bank South, NA. Bank South accepted the draft and deposited it on December 29, 1992, with only the signature of Jerry Peavy, Jr. Both Mr. and Mrs. Peavy, Sr., then wrote checks on the amount of the draft using the full amount to benefit their son.

   On March 30, 1993, Bank South realized that it had improperly deposited the draft because it was lacking an indorsement from Trust Company Bank and reversed the transaction by debiting Mr. and Mrs. Peavy's account for the full amount of the draft. A bank officer then called Mr. and Mrs. Peavy, told them what had happened with the draft, and "threatened to send them to jail if they did not immediately deposit the sum of $5,323.60." The Peavys deposited that amount from the sale of some stock they owned and then filed suit against Bank South for its conversion of their son's draft and funds. Do the Peavys have a case? [*Peavy v. Bank South*, 474 S.E. 2d 690 (Ga. App.)]

6. Getty Petroleum distributes gasoline through dealer-owned stations. Customers who buy gas at a Getty station can pay by cash or credit card. When a customer uses a credit card, Getty processes the transactions, receives payment from the credit card company, and then issues computer-generated checks payable to dealers to reimburse them for their

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

credit card sales. Many checks, however, are not intended for negotiation and are never delivered to the payees. Instead, Getty uses these checks for bookkeeping purposes, voiding them and then crediting the check amount toward the dealer's future purchases of gasoline from Getty.

Lorna Lewis, a supervisor in Getty's credit processing department, stole over 130 checks, forged the indorsements of the payees by hand or rubber stamp, and then submitted the checks to American Express and other credit card companies to pay her own debts. The credit card companies then forwarded the checks through ordinary banking channels to Chemical Bank, where Getty had its checking account. Chemical Bank honored the checks Lewis had forged.

Getty, on discovering the larceny of Lewis, sought recovery of the amounts from the credit card companies. Getty sought payment on 31 of the checks from American Express (which had been paid by Chemical Bank). At trial, a judge held American Express liable to Getty for $58,841.60. The appeals court found that American Express was grossly negligent in taking and cashing the checks and also held it liable. American Express appealed. Who wins and why? [*Getty Petroleum Corp. v. American Exp. Travel Related Services Co., Inc.*, 683 N.E.2d 311 (N.Y.)]

7. Snug Harbor Realty Co. had a checking account in First National Bank. When construction work was obtained by Snug Harbor, its superintendent, Magee, would examine the bills submitted for labor and materials. He would instruct the bookkeeper which bills were approved, and the bookkeeper then prepared the checks in accordance with his instructions. After the checks were signed by the proper official of Snug Harbor, Magee picked them up for delivery. Instead of delivering certain checks, he forged the signatures of the respective payees as indorsers and cashed the checks. The drawee bank then debited the Snug Harbor account with the amount of the checks. Snug Harbor claimed that this was improper and sued the bank for the amount of the checks. The bank claimed that it was protected by the impostor rule. Will the bank be successful? Explain. [*Snug Harbor Realty Co. v. First National Bank*, 253 A.2d 581 (N.J. Super.)]
8. Benton, as agent for Savidge, received an insurance settlement check from Metropolitan Life Insurance Co. He indorsed it "For deposit" and deposited it in Bryn Mawr Trust Co. in Savidge's account. What were the nature and effect of this indorsement? [*Savidge v. Metropolitan Life Ins. Co.*, 110 A.2d 730 (Pa.)]
9. Allstate Insurance Company issued a check payable to "Chuk N. Tang & Rosa C. Tang HWJT" with "Bank of America" on the second line and the following explanation on the front of the check: "Settlement of our rental dwelling loss caused by fire on 11/21/93." The Tangs indorsed the check and forged the indorsement of Bank of America. When Bank of America objected, the Tangs claimed that only they needed to sign the instrument for further negotiations. The check was intended as a joint payment for Bank of America as the mortgagee on the Tangs' rental property because the insurance policy required that the mortgagee be paid first before any proceeds went to the property owners. Bank of America sued Allstate. Is Bank of America entitled to recover for the lack of its indorsement? Was its indorsement necessary for further negotiation? [*Bank of America Nat'l Trust & Savings Ass'n v. Allstate Insurance Co.*, 29 F. Supp. 2d 1129 (C.D. Cal.)]
10. When claims filed with an insurance company were approved for payment, they were given to the claims clerk, who would prepare checks to pay those claims and then give the checks to the treasurer to sign. The claims clerk of the insurance company made a number of checks payable to persons who did not have any claims and gave them to the treasurer with the checks for valid claims, and the treasurer signed all of the checks. The claims clerk then removed the false checks, indorsed them with the names of their respective payees, and cashed them at the bank where the insurance company had its account. The bank debited the account of the insurance company with the amount of these checks. The insurance company claimed that the bank could not do this because the indorsements on the checks were forgeries. Was the insurance company correct? [*General Accident Fire & Life Assur. Corp. v. Citizens Fidelity Bank & Trust Co.*, 519 S.W. 2d 817 (Ky.)]
11. Eutsler forged his brother Richard's indorsement on certified checks and cashed them at First National Bank. When Richard sought to recover the funds from the bank, the bank stated that it would press criminal charges against Eutsler. Richard asked the

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

bank to delay prosecution to give him time to collect directly from his brother. His brother promised to repay him the money but vanished some six months later without having paid any money. Richard sued the bank. What result? [*Eutsler v. First Nat'l Bank, Pawhuska*, 639 P.2d 1245 (Okla.)]

12. Michael Sykes, the president of Sykes Corp., hired Richard Amelung to handle the company's bookkeeping and deal with all of its vendors.

    Amelung entered into an agreement with Eastern Metal Supply to help reduce Sykes's debt to Eastern. Whenever Sykes received a check, Amelung would sign it over to Eastern and allow it to keep 30 percent of the check amount. On 28 checks that totaled $200,000, Amelung indorsed the back as follows: "Sykes & Associates or Sykes Corporation, Richard Amelung." Amelung then turned the checks over to Eastern, and Eastern deposited them into its account at Barnett Bank. Eastern would then write one of its checks to Sykes Corp. for the 70 percent remaining from the checks. When Michael Sykes learned of the arrangement, he demanded the return of the 30 percent from Barnett Bank, claiming that it had paid over an unauthorized signature and that the indorsement was restricted and had been violated by the deposit into Eastern's account. What type of indorsement did Amelung make? Did he have the authority to do so? Should Sykes be reimbursed by Barnett? [*Sykes Corp. v. Eastern Metal Supply, Inc.*, 659 So. 2d 475 (Fla. App.)]

13. In January 1998, Allied Capital Partners, L.P., and American Factors Corporation were in the business of factoring accounts receivable for third-party clients. Allied assigned its factoring contract with Complete Design, Inc., to American but retained an interest in the factoring of Complete Design's invoices. On January 25, 1998, in payment of invoices issued by Complete Design, Clark Wilson Homes, Inc., issued a check for $6,823.15. The check was payable to:

    Complete Design Allied Capital Partners, L.P.
    2340 E. Trinity Mills Ste. 300 Carrollton, Texas 75006

    On February 10, 1998, Clark Wilson issued another check for $26,329.32 made payable to:

    Complete Design Allied Capital Partners, L.P.
    2340 E. Trinity Mills Ste. 300 Carrollton, Texas 75006

    Complete Design deposited both checks in its account at Bank One. However, Allied and American received none of the proceeds of the checks.

    Complete Design subsequently declared bankruptcy, and Allied and American made demand on Bank One for damages resulting from Bank One's conversion of the two checks. Bank One denied all liability for conversion of the checks. Allied and American subsequently sued Bank One, asserting conversion. Bank One filed a motion for summary judgment asserting that, because it was ambiguous to whom the checks at issue were payable, they were payable upon a single indorsement. The trial court granted Bank One's motion. Allied and American appealed. Who is correct here? Were both signatures necessary for a proper indorsement, or will one do? [*Allied Capital Partners, L.P. v. Bank One, Texas, N.A.*, 68 S.W.3d 51 (Tex. App.)]

14. Would a bank be liable to a customer who indorsed a check "For deposit only into account #071698570" if that check were deposited into the wrong account? What if the customer's indorsement was "For deposit only"? Would any account qualify? Would any bank qualify? [*Qatar v. First American Bank of Virginia*, 885 F. Supp. 849 (E.D. Va.)]

15. What would happen if an employee directed funds to his or her account electronically? Would the UCC rules on fictitious payees apply? [*Koss Corp. v. American Exp. Co.*, 309 P.3d 898 (Ariz. App.)]

CPA Questions

1. Hand executed and delivered to Rex a $1,000 negotiable note payable to Rex or bearer. Rex then negotiated it to Ford and indorsed it on the back by merely signing his name. Which of the following is a correct statement?

    a. Rex's indorsement was a special indorsement.

    b. Rex's indorsement was necessary to Ford's qualification as a holder.

    c. The instrument initially being bearer paper cannot be converted to order paper.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

d. The instrument is bearer paper, and Ford can convert it to order paper by writing "pay to the order of Ford" above Rex's signature.

2. Jane Lane, a sole proprietor, has in her possession several checks that she received from her customers. Lane is concerned about the safety of the checks since she believes that many of them are bearer paper that may be cashed without endorsement. The checks in Lane's possession will be considered order paper rather than bearer paper if they were made payable (in the drawer's handwriting) to the order of:

a. Cash.

b. Ted Tint, and indorsed by Ted Tint in blank.

c. Bearer, and indorsed by Ken Kent, making them payable to Jane Lane.

d. Bearer, and indorsed by Sam Sole in blank.

3. West Corp. received a check that was originally made payable to the order of one of its customers, Ted Burns. The following indorsement was written on the back of the check:

Ted Burns, without recourse, for collection only

Which of the following describes the indorsement?

	Special	*Restrictive*
a.	Yes	Yes
b.	No	No
c.	No	Yes
d.	Yes	No

4. An instrument reads as follows:

$250.00 Chicago, Illinois April 1, 1992
Thirty days after date I promise to pay to the
order of Cash
Two hundred and fifty Dollars at
New York City

Value received with interest at the rate of six percent per annum. This agreement arises out of a separate agreement.

No. 20 Due May 1, 1992 Robert Smith

Answer "Yes" or "No" for the following questions about the previous item.

a. The instrument is a draft.

b. The instrument is order paper.

c. This is a negotiable instrument.

d. Robert Smith is the maker.

e. The instrument may be negotiated without indorsement.

5. Ashley needs to endorse a check that had been endorsed by two other individuals prior to Ashley's receipt of the check. Ashley does not want to have surety liability, so Ashley endorses the check "without recourse." Under the Negotiable Instruments Article of the UCC, which of the following types of endorsement did Ashley make?

a. Blank

b. Special

c. Qualified

d. Restrictive

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

C H A P T E R 29

Liability of the Parties under Negotiable Instruments

29-1 Parties to Negotiable Instruments: Rights and Liabilities
- 29-1a Types of Parties
- 29-1b Ordinary Holders and Assignees
- 29-1c The Holder-in-Due-Course Protections

29-2 Defenses to Payment of a Negotiable Instrument
- 29-2a Classification of Defenses
- 29-2b Defenses against Assignee or Ordinary Holder
- 29-2c Limited Defenses Not Available against a Holder in Due Course
- 29-2d Universal Defenses Available against All Holders
- 29-2e Denial of Holder-in-Due-Course Protection

29-3 Liability Issues: How Payment Rights Arise and Defenses Are Used
- 29-3a The Roles of Parties and Liability
- 29-3b Attaching Liability of the Primary Parties: Presentment
- 29-3c Dishonor and Notice of Dishonor

Learning Outcomes

After studying this chapter, you should be able to

LO.1 Distinguish between an ordinary holder and a holder in due course

LO.2 List the requirements for becoming a holder in due course

LO.3 Explain the rights of a holder through a holder in due course

LO.4 List and explain the limited defenses not available against a holder in due course

LO.5 List and explain the universal defenses available against all holders

LO.6 Describe how the rights of a holder in due course have been limited by the Federal Trade Commission

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CPA

29-1 Parties to Negotiable Instruments: Rights and Liabilities

Chapters 27 and 28 introduced the requirements for negotiable instruments and the methods for transfer of those instruments. However, the requirements of negotiability and transfer are simply preliminary steps for the discovery of the real benefit of using negotiable instruments in commerce, which is to streamline payment in commercial transactions. The rights and defenses of the parties to negotiable instruments are determined by the types of parties involved.

29-1a Types of Parties

assignee–third party to whom contract benefits are transferred.

holder–someone in possession of an instrument that runs to that person (i.e., is made payable to that person, is indorsed to that person, or is bearer paper).

holder in due course–a holder who has given value, taken in good faith without notice of dishonor, defenses, or that instrument is overdue, and who is afforded special rights or status.

Parties with rights in a negotiable instrument can be **assignees** or **holders.** A holder may be an ordinary holder or a **holder in due course.** As noted in Chapter 27, a holder in due course is a special party to an instrument with special rights beyond those of the ordinary holder.

29-1b Ordinary Holders and Assignees

A holder is a party in possession of an instrument that runs to him. An instrument "runs" to a party if it is payable to his order, is bearer paper, or is indorsed to him (see Chapter 28). Any holder has all of the rights given through and under the negotiable instrument. The holder may demand payment or bring suit for collection on the instrument. A holder can give a discharge or release from liability on the instrument. A holder who seeks payment of the instrument is required only to produce the instrument and show that the signature of the maker, drawer, or indorser is genuine. If the party obligated to pay under the instrument has no valid defense (such as forgery, which was discussed in Chapter 28), the holder is entitled to payment of the instrument.

The holder can recover from any of the parties who are liable on the instrument, regardless of the order of the signatures on the instrument. A holder could recover from the first indorser on an instrument or from the last party to indorse the instrument.

The rights of a holder are no different from the rights of a contract assignee (see Chapter 17). The assignee of a contract is in the same position and has the same rights as an ordinary holder. **For Example,** if a farmer who signed a note to pay for his tractor has a warranty problem with the tractor, he has a defense to payment on the note. Anyone who is assigned that note as an assignee or holder is also subject to the farmer's defense. (See Figure 29-1 and also the provisions on consumer credit protection under the discussion of the Federal Trade Commission rule in Chapter 32 and later in this chapter.)

CPA

29-1c The Holder-in-Due-Course Protections

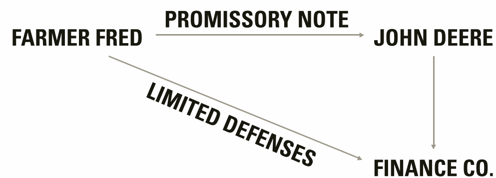
The law gives certain holders of negotiable instruments special rights by protecting them from certain defenses. This protection makes negotiable instruments more attractive and allows greater ease of transfer. Unlike ordinary holders or assignees, holders in due course take free of contract assignment defenses that are good against ordinary holders or assignees. Figure 29-1 shows the different rights of holders, assignees, and holders in due course.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

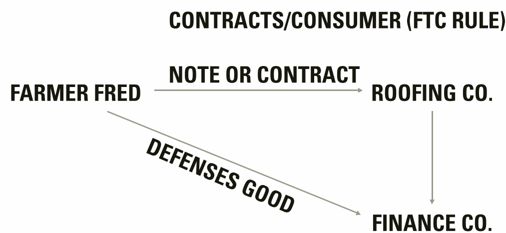
FIGURE 29-1 Assignee, Holder, and Holder-in-Due-Course Rights

Suppose that Farmer Fred signs an installment contract to purchase a tractor from John Deere for $153,000. John Deere assigns the contract to Finance Co.

Suppose that Farmer Fred signs a negotiable promissory note for $153,000 and John Deere then transfers it to Finance Co., a holder in due course.



Suppose that Farmer Fred has a roofing company replace the roof on his home, and he signs a negotiable promissory note for $5,000. Roofing Co. transfers the note to Finance Co.



Holder in Due Course (HDC)

To obtain the preferred status of a holder in due course,[1] a person must first be a holder. However, the preferred status of HDC requires additional standards. Those holders who do not meet the standards for an HDC have all the rights of a holder. However, HDCs enjoy additional protections beyond those basic holder rights. Under U.C.C. §3-302(a), there are four requirements for becoming an HDC.[2]

[1] U.C.C. §3-302. Adam J. Levitin, "Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron," 2007 *Columbia L. Rev.* 83 (2007).

[2] U.C.C. §3-302(a). *New Randolph Halsted Currency Exchange, Inc. v. Regent Title Ins. Agency, LLC*, 939 N.E.2d 1024 (Ill. App. 2010).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CPA

value–consideration or antecedent debt or security given in exchange for the transfer of a negotiable instrument or creation of a security interest.

Value. Value is similar to consideration (see Chapter 14). **For Example,** a person who receives a negotiable note as a gift does not give value because gifts are not supported by consideration or value.[3]

A transferee takes an instrument for value when (1) the holder has promised to do something in exchange (such as update a Web site); (2) the transferee takes the instrument as security for a loan (such as when a debtor transfers a promissory note payable to him to the transferee); or (3) the transferee receives the instrument as payment for a debt already due.[4] As with consideration, the courts do not consider whether the value is enough; they determine only whether some value has been given.[5]

Under Article 3, the original payee of a note is not an HDC unless that note is transferred to others and then back to the payee.[6]

A bank does not give value for a deposited check when it credits the depositor's account with the amount of the deposit. The bank gives value to the extent that the depositor is permitted to withdraw funds against that deposit.[7] **For Example,** if Janice deposits a $300 check into her account, which already has $400 in it, Janice's bank does not give value until Janice has written checks or withdrawn funds beyond the existing $400. The code follows FIFO (first in, first out) for drawing on funds. A bank that lets the customer draw on the funds deposited gives value.[8]

CPA

good faith–absence of knowledge of any defects in or problems; "pure heart and an empty head."

close-connection doctrine–circumstantial evidence, such as an ongoing or a close relationship, that can serve as notice of a problem with an instrument.

Good Faith. The element of **good faith** for becoming an HDC requires that a holder of a negotiable instrument act honestly in acquiring the instrument. In addition, the taker must follow reasonable standards of fair dealing.[9] Karl Llewellyn, one of the key drafters of the UCC, said that to comply with reasonable standards and good faith, the party must act with a "pure heart and an empty head."

Bad faith sometimes exists just because the transferee takes the instrument under such odd circumstances. **For Example,** if a transferee buys a note made payable to an estate from an accountant in a bar at midnight, suspicion prevents HDC status.

The **close-connection doctrine** applies in circumstances that indicate a problem with the instrument. Under this doctrine, the holder has taken so many instruments from its transferor or is so closely connected with the transferor that any knowledge the transferor has is deemed transferred to the holder, preventing holder-in-due-course status. Examples include consumer transactions where the holder in due course is a company that regularly does business with a company that has continual problems with consumer complaints.

[3] However, if the donor of the negotiable instrument were a holder in due course, it might be possible under a special Article 3 protection for the heir to also be a holder in due course despite the gift acquisition. U.C.C. §3-302(c) (iii). This protection for gift transfers by holders in due course is called the *shelter provision* (and is covered later in this chapter).

[4] U.C.C. §3-303.

[5] U.C.C. §3-303; *Ocwen Loan Servicing, LLC v. Branaman*, 554 F. Supp. 2d 645 (N.D. Miss. 2008); *Agriliance, LLC v. Farmpro Services, Inc.,* 328 F. Supp. 2d 958 (S.D. Iowa 2003).

[6] U.C.C. §3-302(c).

[7] U.C.C. §4-211.

[8] Allowing a deposit of a check with provisional credit does not make a bank a holder in due course, but on a cashier's check, when the bank becomes both the drawer and the drawee, the bank is obligated to pay on the instrument. *Flatiron Linen, Inc. v. First American State Bank,* 23 P.3d 1209 (Colo. 2011). If the bank does not impose provisional credit and makes the funds available immediately for the customer, it gives value and qualifies as a holder in due course. But see *Travelers Cas. and Sur. Co. of America v. Wells Fargo Bank N.A.*, 374 F.3d 521 (7th Cir. 2004).

[9] U.C.C. §3-103(a)(4); issue of whether a party is a holder in due course is always an issue of fact. *Pasack Community Bank, Inc. v. Universal Funding, LLP,* 16 A.3d 1097 (N.J. App. 2011).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CASE SUMMARY

Embezzling $29,000 and Having an HDC Cash Your Check

FACTS: Regent served as a settlement agent for closing real estate transactions. Regent cut checks to distribute funds to all the parties to such transactions. On December 23, 2005, New Randolph cashed a check from Regent, which was made out to Charae Pearson, for $1,945.99. Four days later, New Randolph cashed another check for Pearson, again from Regent, this time for $2,500. On January 11, 2006, Pearson brought Regent's check number 22221 for $29,588.31 to New Randolph. Unlike the prior checks, which spelled Pearson's name correctly, this check showed the payee as "CHAREA PAERSON." The check indicated that Pearson received it as a "LOAN PAYOFF." Pearson presented the check to Patrice Keys, manager of New Randolph. Pearson showed Keys her state identification card, which had been issued on December 30, 2005. Pearson told Keys that Regent issued the check to her to pay her a commission she earned from the sale of property.

PLS Check Cashers, which owned New Randolph, did not authorize Keys to cash checks in excess of $5,000 without approval from her supervisor. Keys contacted Sandra Arizaga of PLS. Arizaga authorized Keys to cash the check. Arizaga, who worked as director of operations for PLS, testified that she approved about three checks each week for amounts exceeding the amount of Regent's check number 22221. She spoke with Keys about the check, and then she looked up the phone number for Regent at Regent's Web site. Arizaga spoke with a woman who confirmed that Regent issued the check to Pearson in the amount shown. Arizaga then contacted American Chartered Bank, which confirmed that the check came from a valid account with sufficient funds to cover the check, and that Regent had not stopped payment on the check.

Regent introduced PLS's manual into evidence. The manual emphasizes that PLS earns its fees by cashing checks, so the employee should "[s]pend * * * time proving that the check can be cashed and not looking for excuses not to cash it." The manual identifies several signs that a check might not be valid, including several of the factors present in this case. According to the manual, the employee should "verify that the check is good" by "phoning the maker."

Police arrested Pearson, charging her with check fraud. Two days later, police arrested Tatiana Auson, an employee of Regent, on the same charge. Auson had checks intended for parties to real estate transactions canceled and then issued new checks to different payees for the amounts of the original checks. Pearson admitted that Auson gave her the three checks that New Randolph cashed for Pearson. Pearson kept about $5,000 of the proceeds from the checks, and she gave the remainder to Auson. All three checks appeared to bear the signature of Karen Hendricks, who had authority to sign checks on behalf of Regent.

Regent told its bank to stop payment on the check. New Randolph sued Regent for payment of the check, claiming that its status as a holder in due course entitled it to payment, despite the evidence that Auson and Pearson conspired to defraud Regent.

New Randolph appealed.

DECISION: Notice that disqualifies a party from being an HDC is something more than a suspicion. The verification call made in this situation showed the good faith of New Randolph. It checked to be sure that the check was good and was entitled to payment regardless of the embezzlement and breaches of fiduciary duties of their respective employees in working through the transactions. [***New Randolph Halsted Currency Exchange, Inc. v. Regent Title Insurance Co.*, 939 N.E.2d 1024 (Ill. App. 2011)**]

Ignorance of the Instrument's Being Overdue or Dishonored. An instrument can be negotiated even though it has been dishonored, it is overdue,[10] or it is demand paper, such as a check, that has been outstanding for more than a reasonable time.[11] These instruments can still be transferred and the transferee is still a holder. However, the fact that the instrument is circulating at a late date or after it has been dishonored is suspicious and results in notice from the circumstances that there may be some adverse claim or defense. A person who acquires title to the instrument under such circumstances can be a holder but cannot be a holder in due course. **For Example,** buying a discounted note after its due date is notice that something may be wrong with the instrument.

[10] *Erkins v. Alaska Trustee, LLC*, 265 P.3d 292 (Alaska 2011); *Cadle Co. v. DeVincent*, 781 N.E.2d 817 (Mass. App. 2003); *Interim Capital LLC v. Herr Law Group, Ltd.*, 2011 WL 7047062 (D. Nev. 2011).
[11] *Max Duncan Family Investments, Ltd. v. NTFN Inc.*, 267 S.W.3d 447 (Tex. 2008).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Ignorance of Defenses and Adverse Claims. Prior parties on an instrument may have defenses that entitle them to withhold payment from a holder of an instrument. **For Example,** the drawer of a check, upon demand for payment by the payee, could assert as a defense to payment that the merchandise the payee delivered under the terms of their underlying contract was defective. A person who acquires an instrument with notice or knowledge that there is a defense that a party may have or that there are claims of ownership of the instrument from different parties cannot be an HDC. In general, transferees who are aware of facts that would make a reasonable person ask questions are deemed to know what they would have learned if they had asked questions.[12] Such knowledge and the failure to ask questions will cost them their special status of holder in due course; they remain simply holders.

Knowledge acquired by a holder after the instrument was acquired does not prevent the holder from being a holder in due course. The fact that a holder, after acquiring the instrument, learns of a defense does not work retroactively to destroy the holder's character as an HDC.

CASE SUMMARY

Cashing a Postdated Check from an Embezzler: HDC?

FACTS: A check dated August 10, 2007, was made payable to one of Liccardi's employees, Charles Stallone, Jr. Liccardi withheld the check from Stallone because he suspected him of embezzlement. However, the check still disappeared from the company offices, and when the disappearance was discovered, Liccardi immediately placed a stop payment on the check. JCNB Check Cashing, Inc. (JCNB), cashed the check for Stallone before the issue date (the check was postdated) and JCNB then deposited the check in its own bank account on August 9, 2007. However, the issuing bank refused to honor the check. On February 11, 2009, Robert Triffin acquired the dishonored payroll check from JCNB and sued Liccardi and Stallone for the amount of the check plus interest. Triffin's business is buying dishonored checks and attempting to collect on them.

The trial court dismissed Triffin's complaint on the grounds that he was not a holder in due course. Triffin appealed.

DECISION: The Court held that Triffin was not a holder in due course because he had taken a check that was already dishonored. In addition, Triffin could not be a holder in due course through JCNB being a holder in due course, because JCNB did not follow reasonable commercial standards when it cashed the postdated check. New Jersey's statute that regulates check cashing services requires those services to at least examine the face of the instrument before cashing it. JCNB, thus, was not a holder in due course and Triffin could not step into its shoes as an HDC. [***Triffin v. Liccardi Ford, Inc.***, **10 A.3d 227 (N.J. Super. 2011)**]

ETHICS & THE LAW

The Corner Check Cashing Company and Good Faith

Some public policy experts have argued that no check cashing company, defined as one that takes a portion of the amount of the check as a fee for cashing checks for individuals who cannot get them cashed at banks and credit unions, should ever be allowed holder-in-due-course status.

Do you agree with this argument? Are check cashing companies ethical in their behavior? Do you believe that the state laws on check cashing firms are a means of mandating ethical conduct?

[12] *Specialized Loan Servicing, LLC v. January*, 119 So. 3d 582 (La. 2013); *Jelmoli Holding, Inc. v. Raymond James Financial Services, Inc.*, 470 F.3d 14 (1st Cir. 2006).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CPA

Holder Through a Holder in Due Course

holder through a holder in due course–holder of an instrument who attains holder-in-due-course status because a holder in due course has held it previous to him or her.

Those persons who become holders of the instrument after an HDC has held it are given the same protection as the HDC, provided they are not parties to any fraud or illegality that affects the instrument. This status of **holder through a holder in due course** is given in these circumstances even if the transferee from a holder in due course does not satisfy the requirements for holder-in-due-course status. This elevated or protected status is called Article 3's "shelter rule," and it allows a person who is not an HDC to hide under the "umbrella" with a holder in due course and be sheltered from claims and defenses as if actually being an HDC. **For Example,** a person who acquires an instrument as an inheritance from an estate does not give value and is missing one of the requirements for being a holder in due course. However, if the estate was an HDC, that status does transfer to the heir. Furthermore, suppose that Avery is a holder in due course of a $5,000 promissory note due May 31, 2015. Avery gives the note to his nephew Aaron for Aaron's birthday on June 1, 2015. Aaron did not give value because the note was a gift, and he has taken the note as a holder after it has already become due. Nonetheless, because Avery was a holder in due course, Aaron assumes that status under Article 3's shelter provision.

29-2 Defenses to Payment of a Negotiable Instrument

One of the key reasons for attaining HDC status is to be able to obtain payment on the negotiable instrument free of any underlying problems between the original parties to the instrument. An HDC takes an instrument free from certain types of defenses to payment. Whether a defense may be raised against an HDC claiming under a negotiable instrument depends on the nature of the defense.

CPA

29-2a Classification of Defenses

The importance of being a holder in due course or a holder through an HDC is that such holders are not subject to certain defenses called *limited defenses*. Another class of defenses, *universal defenses*, may be asserted against any party, whether an assignee, an ordinary holder, an HDC, or a holder through an HDC.[13]

29-2b Defenses against Assignee or Ordinary Holder

Assignees of negotiable instruments are subject to every defense raised. Similarly, a holder who does not become an HDC is subject to every payment defense just as though the instrument were not negotiable.

29-2c Limited Defenses Not Available against a Holder in Due Course

HDCs are not subject to any of the following defenses.

[13] Under the pre-Code law and under the 1952 Code, the universal defense was called a *real defense*, and the limited defense was called a *personal defense*. These terms have now been abandoned, but some licensing and CPA examinations may continue to use these pre-Code terms.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CPA

Ordinary Contract Defenses

In general terms, the defenses that could be raised in a breach of contract claim cannot be raised against an HDC. 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.

For Example, a businessperson cannot refuse to pay a holder in due course on the note used to pay for her copy machine just because her copy machine does not have the speed she was promised.

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. **For Example,** a promissory note made by an insane person for whom a court has appointed a guardian is void. In the case of a claim on the note by an HDC, the incapacity of the maker would be a defense.

CPA

Fraud in the Inducement

fraud in the inducement–fraud that occurs when a person is persuaded or induced to execute an instrument because of fraudulent statements.

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. **For Example,** suppose Mills is persuaded to purchase an automobile because of Pagan's statements that the car was a demonstrator for the dealership and in good mechanical condition with a certification from the dealership's head mechanic. Mills, a car dealer, gives Pagan a note, which is negotiated until it reaches Han, who is a holder in due course. Mills meanwhile learns that the car has been in an accident and has a cracked engine block, that the head mechanic was paid to sign the certification, and that Pagan's statements were fraudulent. When Han demands payment of the note, Mills cannot refuse to pay on the ground of Pagan's fraud. Mills must pay the note because Han, as an HDC, does not take the note subject to any fraud or misrepresentation in the underlying transaction. Mills is left with the remedy of recovering from Pagan for misrepresentation or fraud.

Miscellaneous Defenses[14]

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 may be asserted: (1) prior payment or cancellation of the instrument, (2) nondelivery, (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. These defenses, however, have a very limited effect in defending against an HDC's demand for payment.

CASE SUMMARY

Fake Rolex; Good Check

FACTS: On September 23, 2011, Houston Gold Exchange issued a $3,500 check as payor to Shelly McKee as payee to buy a purported Rolex watch from her. The check was postdated September 26, 2011. McKee properly endorsed the check and presented it to RR Maloan, which cashed the check for her on September 24, 2011. On September 24, 2011,

[14] U.C.C. §3-305.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Fake Rolex; Good Check continued

Houston Gold Exchange issued a stop payment order on the check based on information that the watch was counterfeit. RR Maloan presented the check to Houston Gold Exchange's bank for payment. Houston Gold Exchange's bank refused to honor the check based on the stop payment order.

RR Maloan sued Houston Gold Exchange to collect on the check. RR Maloan maintained that it was a holder in due course entitled to collect on the check. Houston Gold Exchange was not present on the trial date, and the small claims court signed a default judgment in RR Maloan's favor. On appeal, the trial court found for Houston Gold Exchange, and RR Maloan appealed.

DECISION: A holder in due course takes the instrument free from all claims and all defenses of any party to the instrument with whom he has not dealt unless a defense that bars recovery by a holder in due course applies. RR Maloan took the check "for value" as required. "Good faith" is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing." The record here conclusively establishes RR Maloan's good faith as that concept is defined for these purposes in the statute. No evidence was presented that the owner or any employee of RR Maloan had knowledge at the time the check was accepted that the watch was not authentic.

Because the fact of postdating did not impose a duty on RR Maloan to investigate the surrounding circumstances, Houston Gold Exchange cannot establish that RR Maloan failed to observe "reasonable commercial standards of fair dealing" by failing to investigate based on the postdating of the check.

UCC case law is very clear that fraud by the payee is not a defense against a holder in due course. McKee's asserted fraud in selling an allegedly fake Rolex to Houston Gold Exchange does not bar RR Maloan from collecting on the check as a holder in due course.

Reversed and remanded.

[*RR Maloan Investments, Inc. v. New HGE, Inc.*, 428 S.W.3d 355 (Tex. App. 2014)]

29-2d Universal Defenses Available against All Holders

Certain defenses are regarded as so basic that the social interest in preserving them outweighs the social interest of giving negotiable instruments the freely transferable qualities of money. Accordingly, such defenses are given universal effect and may be raised against all holders, whether ordinary holders, HDCs, or holders through a holder in due course. These defenses are called **universal defenses.**[15]

universal defenses– defenses that are regarded as so basic that the social interest in preserving them outweighs the social interest of giving negotiable instruments the freely transferable qualities of money; accordingly, such defenses are given universal effect and may be raised against all holders.

CPA

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.[16] When one person induces another to sign a note by falsely representing that, for example, it is a contract for repairs or that it is a character reference, the note is invalid, and the defense of the misrepresentation of the character of the instrument can be used against a holder in due course. **For Example,** suppose that two homeowners are asked to sign a statement for a salesperson that he was in their home and did a demonstration of a new solar water heater. Just as the homeowners are about to sign the verification statement, the salesman distracts them and then switches the verification for a purchase contract and promissory note for a $5,000 solar water heating system that the owners declined to purchase. The owners would have a defense of fraud in factum against a holder in due course of this note. The difference between fraud in the inducement—a personal defense—and fraud in factum—a universal defense—is that fraud in factum involves deception as to the documents themselves, not as to the underlying goods, services, or property.

[15] *City Rentals, Inc. v. Kessler*, 946 N.E.2d 785 (Ohio App. 2010).
[16] U.C.C. §3-305(a)(1)(iii).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CPA

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 HDC. The fact that the negligence of the drawer helped the wrongdoer does not prevent the drawee from raising the defense of forgery. (See Chapters 28 and 30 for more discussion of the impact of forgery on liability.)

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 of this type and level may be raised as a defense against any holder. Economic duress, in the form of a reluctance to enter into a financially demanding instrument, is not a universal defense.[17] Duress that is attempted murder 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.[18]

Illegality

If an instrument is void by law when executed in connection with certain conduct, such as a note for gambling or one that involves usury, such defenses may be raised against an HDC.

CPA

Alteration

alteration–unauthorized change or completion of a negotiable instrument designed to modify the obligation of a party to the instrument.

An **alteration** is an unauthorized change or completion of a negotiable instrument designed to modify the obligation of a party to the instrument.[19] **For Example,** changing the amount of an instrument from $150 to $450 is an alteration.[20]

Person Making Alteration. An alteration is a change made by a party to the instrument. Recovery on the instrument is still possible under the terms of the instrument as it originally existed, if proof of the original terms is possible.

Effect of Alteration. If the alteration to the instrument was made fraudulently, the person whose obligations under the instrument are affected by that alteration is discharged from liability on the instrument. The instrument, however, can be enforced according to its original terms or its terms as completed. This right of enforcement is given to holders in due course who had no notice of such alteration.[21] While a holder in due course would come within the protected class on alteration, such status is not required for this recovery provision in the event of alteration. **For Example,** Ryan signed a negotiable demand note for $100 made payable to Long. A subsequent holder changed the amount from $100 to

[17] *JPMorgan Chase Bank, N.A. v. Asia Pulp & Paper Cp., Ltd.*, 707 F.3d 853 (7th Cir. 2013).

[18] U.C.C. §3-305(a)(1)(ii). *Erkins v. Alaska Trustee LLC*, 265 P.3d 292 (Alaska 2011).

[19] U.C.C. §3-407(a); *Stahl v. St. Elizabeth Medical Center,* 948 S.W.2d 419 (Ky. App. 1997). *Farmers Deposit Bank v. Bank One*, 2005 WL 3453979 (E.D. Ky. 2005). A material alteration made based on the parties' negotiations (a 13 percent versus an 18 percent interest rate) is not fraudulent. *Darnall v. Petersen,* 592 N.W.2d 505 (Neb. App. 1999); *Knoefler v. Wojtalewicz,* 2003 WL 21496933 (Neb. App. 2003) (difference between bank interest rate and judgment interest rate is not material).

[20] However, if an instrument, such as a note, has been altered and the maker continues to pay without objection to the alteration, the alteration does not discharge the maker's liability. *Richard v. Wells Fargo Bank, N.A.*, 2013 WL 5726009 (Mo. App. 2013).

[21] U.C.C. §3-407(b), (c).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

FIGURE 29-2 Defenses to Payment of Negotiable Instrument

UNIVERSAL (Available against assignees, holders, and holders in due course) (Real)	LIMITED (Available against assignees and holders but not against holders in due course) (Personal)	MIXED (Circumstances vary the availability of these defenses)
Fraud as to the nature of the instrument (fraud in factum)	Fraud in the inducement	Duress
Forgery	Misrepresentation	Incapacity
Unauthorized signature	Lack of consideration	
Incapacity (declaration)	Breach of warranty	
Illegality	Cancellation	
Alteration	Failure of delivery	
Consumer credit contracts with FTC notice	Unauthorized completion	
	All ordinary contract defenses	

$700. A later holder in due course presented the note to Ryan for payment. Ryan would still be liable for the original amount of $100.

A summary of the universal and limited defenses is presented in Figure 29-2.

29-2e Denial of Holder-in-Due-Course Protection

In certain situations, the taker of a negotiable instrument is denied the status and protections of an HDC.

Participating Transferee

When the transferee is working with the lender or seller to obtain a negotiable instrument from the buyer/borrower, the transferee's holder-in-due-course status comes into question. This close-connection doctrine (discussed earlier in this chapter as an issue in the good-faith requirement for becoming a holder in due course) prevents a transferee with intimate knowledge of the transferor's business practices from becoming an HDC.[22]

The Federal Trade Commission Rule

In 1976, the Federal Trade Commission (FTC) adopted a rule that limits the rights of a holder in due course in a consumer credit transaction. The rule protects consumers who

[22] In re *Neals*, 459 B.R. 612 (D.S.C. 2011). *AIG Global Securities Lending Corp. v. Banc of America Securities LLC*, 2006 WL 1206333 (S.D.N.Y. 2006).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

purchase goods or services for personal, family, or household use on credit.[23] When the note the buyer gave the seller as payment for the consumer goods is transferred to even a holder in due course, the consumer buyer may raise any defense that could have been raised against the seller. The FTC regulation requires that the following notice be included in boldface type at least 10 points in size in consumer credit contracts covered under the rule:

> *Notice*
> *Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.*

When a notice preserving consumer defenses is included in a negotiable instrument, no subsequent person can be a holder in due course of the instrument.[24]

primary party–party to whom the holder or holder in due course must turn first to obtain payment.

maker–party who writes or creates a promissory note.

drawee–person to whom the draft is addressed and who is ordered to pay the amount of money specified in the draft.

29-3 Liability Issues: How Payment Rights Arise and Defenses Are Used

In this chapter and in Chapters 27 and 28, issues surrounding the types of instruments, transfers, holders, and holders in due course have been covered. However, there are procedures under Article 3 for bringing together all of the parties, instruments, and defenses so that ultimate liability and, hopefully, payment can be determined and achieved.

CPA

29-3a The Roles of Parties and Liability

secondary parties–called secondary obligors under Revised Article 3; parties to an instrument to whom holders turn when the primary party, for whatever reason, fails to pay the instrument.

indorser–secondary party (or obligor) on a note.

drawer–person who writes out and creates a draft or bill of exchange, including a check.

Every instrument has primary and secondary parties. The **primary party** is the party to whom the holder or holder in due course must turn first to obtain payment. The primary party on a note or certificate of deposit is the **maker.** The primary party on a draft is the **drawee,** assuming that the drawee has accepted the draft. Although a check must first be presented to the drawee bank for payment, the bank is not primarily liable on the instrument because the bank has the right to refuse to pay the check (see following and Chapter 30). The drawee bank on a check is the party to whom a holder or holder in due course turns first for payment despite the lack of primary-party status on the part of that drawee bank. The maker of a note is the party to whom holders and holders in due course must turn first for payment.

The **secondary parties** (or *secondary obligors*, as they are now called under Article 3) to an instrument are those to whom holders turn when the primary party, for whatever reason, fails to pay the instrument. Secondary parties on notes are **indorsers,** and secondary parties on checks and drafts are **drawers** and indorsers.

CPA

29-3b Attaching Liability of the Primary Parties: Presentment

presentment–formal request for payment on an instrument.

Presentment occurs when the holder or HDC of an instrument orally, in writing, or by electronic communication to the primary party requests that the instrument be paid

[23] The regulation does not cover purchases of real estate, securities, or consumer goods or services for which the purchase price is more than $25,000. *Fifth Third Bank v. Jones*, 168 P.3d 1 (Colo. App. 2007).

[24] U.C.C. §3-106(d). The rule changes the status of the parties as holders in due course. It does not change contract rights. *Pennsylvania Dept. of Banking v. NCAS of Delaware, LLC*, 931 A.2d 771 (Pa. 2007).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

E-COMMERCE & CYBERLAW

Electronic Presentment: One Fell Swoop, All Rights, All Payments, New Laws

Because we now use debit cards, some of the UCC Article 3 provisions on checks are used far less, and the rights of the merchants and the buyers are covered under various federal and state laws on electronic funds transfers (covered in Chapter 30). Issues continue to evolve, such as the protections on debit cards and credit cards and increasing cyber security at banks and stores to prevent hackers from obtaining information, including card and pin numbers.

THINKING THINGS THROUGH

The Corner Check Cashing Company and Thieves—Who Wins?

Now is an ideal time to bring together all of the concepts you have learned in Chapters 26, 27, and 28. Analyzing this problem will help you integrate your knowledge about negotiable instruments. Sid's Salmon has purchased salmon from Fred's Fisheries. Sid wrote a check for $22,000 to Fred's. A thief broke into Fred's offices and took the cash on hand as well as the unindorsed check from Sid's. The thief took the check to the Corner Check Cashing Company (CCCC) and received $22,000 less the cashing fee of $2,000. Fred notified Sid, who then notified First Commerce Bank, the drawee of the check, of the theft. CCCC has presented the check for payment, and First Commerce refuses to pay. CCCC says it is a holder in due course.

Are you able to help First Commerce Bank develop its response to CCCC? Suppose that Fred had already indorsed the check when the thief stole it. Would CCCC be a holder in due course?

according to its terms. The primary party has the right to require that the presentment be made in a "commercially reasonable manner," which would include reasonable times for presentment, such as during business hours. The primary party can also require identification, authorization, and even a signature of receipt of the funds due under the instrument. In addition, the primary party can demand a valid indorsement on the instrument prior to making payment. Upon presentment, the primary party is required to pay according to the terms of the instrument unless there are defenses such as forgery, any of the other universal defenses for HDCs, or any defenses for holders.

dishonor–status when the primary party refuses to pay the instrument according to its terms.

If the primary party refuses to pay the instrument according to its terms, there has been a *dishonor*, and the holder is then left to turn to the secondary parties.

CPA

29-3c Dishonor and Notice of Dishonor

notice of dishonor–notice that an instrument has been dishonored; such notice can be oral, written, or electronic but is subject to time limitations.

limited defenses–defenses available to secondary parties if the presenting party is a holder in due course.

Dishonor occurs when the primary party refuses to pay the instrument according to its terms. The primary party is required to give **notice of dishonor.** The notice that the instrument has been dishonored can be oral, written, or electronic. That notice is subject to time limitations. **For Example,** a bank must give notice of dishonor by midnight of the next banking day. Nonbank primary parties must give notice of dishonor within 30 days following their receipt of notice of dishonor. Returning the dishonored check is sufficient notice of dishonor. (See Chapter 30 for more discussion of liability issues on dishonor of checks.) Upon dishonor, the holder must then turn to the secondary parties for payment.

The obligation of the secondary parties in these situations is to pay according to the terms of the instrument. These secondary parties will have **limited defenses** if the presenting party is a holder in due course. **For Example,** suppose that a check drawn on

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

First Interstate Bank is written by Ben Paltrow to Julia Sutherland as payment for Julia's Bentley auto that Ben purchased. Julia deposits Ben's check into her account at AmeriBank, and AmeriBank sends the check to First Interstate to present it for payment. First Interstate finds that Ben's account has insufficient funds and dishonors the check. AmeriBank must notify First Interstate by midnight of the next banking day that the check has been dishonored, and then First Interstate must notify Julia by midnight of the next banking day that Ben's check was dishonored. Julia then has 30 days to notify Ben and turn to him as a drawer, or secondary party, for payment on the check.

Make the Connection

Summary

A holder of a negotiable instrument can be either an ordinary holder or an HDC. The ordinary holder has the same rights that an assignee would have. Holders in due course and holders through an HDC are protected from certain defenses. To be an HDC, a person must first be a holder—that is, the person must have acquired the instrument by proper negotiation. The holder must then also take for value, in good faith, without notice that the paper is overdue or dishonored, and without notice of defenses and adverse claims. Those persons who become holders of the instrument after an HDC are given the same protection as the HDC through the shelter provision, provided they are not parties to any fraud or illegality affecting the instrument.

The importance of being an HDC is that those holders are not being subject to certain defenses when demand for payment is made. These defenses are limited defenses and include ordinary contract defenses, incapacity unless it makes the instrument void, fraud in the inducement, prior payment or cancellation, nondelivery of an instrument, conditional delivery, duress consisting of threats, unauthorized completion, and theft of a bearer instrument. Universal defenses may be asserted against any assignee, an ordinary holder, or HDC. Universal defenses include fraud as to the nature or essential terms of the paper, forgery or lack of authority, duress depriving control, incapacity, illegality that makes the instrument void, and alteration. Alteration is only a partial defense; an HDC may enforce the instrument according to its original terms.

The Federal Trade Commission rule on consumer credit contracts limits the immunity of an HDC from defenses of consumer buyers against their sellers. Immunity is limited in consumer credit transactions if the notice specified by the FTC regulation is included in the sales contract. When a notice preserving consumer defenses is stated in a negotiable instrument, no subsequent person can be an HDC.

Holders and HDCs are required to present instruments for payment to primary parties. Primary parties are makers and drawees. If the primary party refuses to pay, or dishonors, the instrument, it must give notice of dishonor in a timely fashion. The holder can then turn to secondary parties, drawers, and indorsers (secondary obligors) for payment.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

29-1 Parties to Negotiable Instruments: Rights and Liabilities

LO.1 Distinguish between an ordinary holder and a holder in due course

See the sections titled "Ordinary Holders and Assignees" and "The Holder-in-Due-Course Protections" for examples of distinction, pages 556–561.

LO.2 List the requirements for becoming a holder in due course

See the *Triffin v. Liccardi Ford, Inc.* case, page 560.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

29-2 Defenses to Payment of a Negotiable Instrument

LO.3 Explain the rights of a holder through a holder in due course

See the *New Randolph Halsted Currency Exchange, Inc. v. Regent Title Insurance Co.* case, page 559.

LO.4 List and explain the limited defenses not available against a holder in due course

See the list of defenses in Figure 29-2, page 565.

See the *RR Maloan Investments, Inc. v. New HGE, Inc.* case, pages 562–563.

LO.5 List and explain the universal defenses available against all holders

See the Thinking Things Through discussion of the Corner Check Cashing Company, page 567.

See the ethical issue on check cashing companies, page 560.

29-3 Liability Issues: How Payment Rights Arise and Defenses Are Used

LO.6 Describe how the rights of a holder in due course have been limited by the Federal Trade Commission

See the language of the rule, page 566.

Key Terms

alteration
assignees
close-connection doctrine
dishonor
drawee
drawers
fraud in the inducement
good faith
holders
holder in due course
holder through a holder in due course
indorsers
limited defenses
maker
notice of dishonor
presentment
primary party
secondary parties
universal defenses
value

Questions and Case Problems

1. Randy Bocian had a bank account with First of America-Bank (FAB). On October 8, Bocian received a check for $28,800 from Eric Christenson as payment for constructing a pole barn on Christenson's property. Bocian deposited the check at FAB on October 9 and was permitted to draw on the funds through October 12. Bocian wrote checks totaling $12,334.21, which FAB cleared. On October 12, Christenson stopped payment on the check as the result of a contract dispute over the pole barn. Bocian's account was then overdrawn once the check was denied clearance by Christenson's bank. FAB brought suit against both Bocian and Christenson to collect its loss. Christenson counterclaimed against Bocian for his contract breach claims on the pole barn construction. FAB maintained that it had given value and was a holder in due course and that, as such, it was not required to be subject to the pole barn issues or the stop payment order. Is FAB right? [*First of America-Bank Northeast Illinois v. Bocian*, 614 N.E.2d 890 (Ill. App.)]
2. Cronin, an employee of Epicycle, cashed his final paycheck at Money Mart Check Cashing Center. Epicycle had issued a stop payment order on the check. Money Mart deposited the check through normal banking channels. The check was returned to Money Mart marked "Payment Stopped." Money Mart brought an action against Epicycle, claiming that, as a holder in due course, it was entitled to recover against Epicycle. Epicycle argued that Money Mart could not be a holder in due course because it failed to verify the check as good prior to cashing it. Is Money Mart a holder in due course? [*Money Mart Check Cashing Center, Inc. v. Epicycle Corp.*, 667 P.2d 1372 (Colo.)]
3. Halleck executed a promissory note payable to the order of Leopold. Halleck did not pay the note when due, and Leopold brought suit on the note, producing it in court. Halleck admitted that he had signed the note but claimed plaintiff Leopold was required to prove that the note had been issued for consideration and that the plaintiff was in fact the holder. Are these elements of proof required as part of the case? [*Leopold v. Halleck*, 436 N.E.2d 29 (Ill. App.)]
4. Calhoun/Johnson Company d/b/a Williams Lumber Company (Williams) sold building materials to Donald Miller d/b/a Millercraft Construction Company (Millercraft) on credit. Miller had signed a personal guaranty for the materials. Miller requested lien waivers from Williams for four of his projects

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

and asked for them from Fabian Boudreau, Williams's credit manager. Fabian refused to grant the waivers because Miller was $28,000 delinquent on his account. Miller agreed to bring his account current with the exception of $11,000 for which he signed a no-interest promissory note. Miller obtained the lien waivers and then defaulted on the note. Williams brought suit for payment, and Williams said there was lack of consideration and that the note was not valid. He said he must give value to be able to recover on the note. Was he correct? [*Miller v. Calhoun/Johnson Co.*, 497 S.E.2d 397 (Ga. App.)]

5. Jane bought a string of pearls from Grantham Jewelers. Jane wrote a check for $1,760 to pay for the pearls. When Jane had the pearls appraised for insurance purposes, she learned from the appraiser that the pearls were fake. Jane stopped payment on the check. However, Grantham had transferred the check to Jim Holub, who had then transferred the check back to Grantham. Is Grantham an HDC?
6. Can check cashing companies be holders in due course? What arguments can you make for and against their holder-in-due-course status? [*Dal-Tile Corp. v. Cash N' Go*, 487 S.E.2d 529 (Ga. App.)]
7. Jones, wishing to retire from a business enterprise that he had been conducting for a number of years, sold all of the assets of the business to Jackson Corp. Included in the assets were a number of promissory notes payable to the order of Jones that he had taken from his customers. Upon the maturity of one of the notes, the maker refused to pay because there was a failure of consideration. Jackson Corp. sued the maker of the note. Who should succeed? Explain.
8. Elliot, an officer of Impact Marketing, drew six postdated checks on Impact's account. The checks were payable to Bell for legal services to be subsequently performed for Impact. Financial Associates purchased them from Bell and collected on four of the checks. Payment was stopped on the last two when Bell's services were terminated. Financial argued that it was a holder in due course and had the right to collect on the checks. Impact claimed that because the checks were postdated and issued for an executory promise, Financial could not be a holder in due course. Who was correct? Why? [*Financial Associates v. Impact Marketing*, 394 N.Y.S.2d 814]
9. *D* drew a check to the order of *P*. *P* took the check postdated. *P* knew that *D* was having financial difficulties and that the particular checking account on which this check was drawn had been frequently overdrawn. Do these circumstances prevent *P* from being a holder in due course? [*Citizens Bank, Booneville v. National Bank of Commerce*, 334 F.2d 257 (10th Cir.); *Franklin National Bank v. Sidney Gotowner*, 4 U.C.C. Rep. Serv. 953 (N.Y. Supp.)]
10. Daniel, Joel, and Claire Guerrette are the adult children of Elden Guerrette, who died on September 24, 1995. Before his death, Elden purchased a life insurance policy from Sun Life Assurance Company of Canada through a Sun Life agent, Steven Hall, and named his children as his beneficiaries. Upon his death, Sun Life issued three checks, each in the amount of $40,759.35, to each of Elden's children. The checks were drawn on Sun Life's account at Chase Manhattan Bank in Syracuse, New York. The checks were given to Hall for delivery to the Guerrettes. Hall and an associate, Paul Richard, then fraudulently induced the Guerrettes to indorse the checks in blank and to transfer them to Hall and Richard, purportedly to be invested in HER, Inc., a corporation formed by Hall and Richard. Hall took the checks from the Guerrettes and turned them over to Richard, who deposited them in his account at the Credit Union on October 26, 1995. The Credit Union immediately made the funds available to Richard.

    The Guerrettes quickly regretted having negotiated their checks to Hall and Richard, and they contacted Sun Life the next day to request that Sun Life stop payment on the checks. Sun Life immediately ordered Chase Manhattan to stop payment on the checks. When the checks were ultimately presented to Chase Manhattan for payment, Chase refused to pay the checks, and they were returned to the Credit Union. The Credit Union received notice that the checks had been dishonored on November 3, 1995, the sixth business day following their deposit. By the time the Credit Union received notice, however, Richard had withdrawn from his account all of the funds represented by the three checks. The Credit Union was able to recover almost $80,000 from Richard, but there remained an unpaid balance of $42,366.56.

    The Credit Union filed suit against Sun Life, and all of the parties became engulfed in litigation. The Credit Union indicated it was a holder in due course and was entitled to payment on the instrument. Sun Life alleged fraud. Is the Credit Union a holder in due course? Can the parties allege the fraud defense against it? [*Maine Family Federal Credit*

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Union v. Sun Life Assur. Co. of Canada, 727 A.2d 335 (Maine)]

11. G.C. Vincent was an employee of Porter County Development Corporation (PCDC). Vincent had three personal credit cards through Citibank. Vincent diverted checks to the PCDC, deposited them into his personal checking account, and issued checks drawn upon that personal account to pay part of the outstanding balance of his three Citibank-held credit card accounts. Citibank was unaware that Vincent used misappropriated funds to pay his credit card balance. PCDC filed suit to have Citibank return the embezzled funds. Citibank moved for summary judgment on the grounds that it was an HDC. The trial court granted summary judgment and PCDC appealed. Who should prevail on appeal and why? [*Porter County Development Corp. v. Citibank (South Dakota)*, N.A., 855 N.E.2d 306 (Ind. App.)]

12. Sanders gave Clary a check but left the amount incomplete. The check was given as advance payment on the purchase of 100 LT speakers. The amount was left blank because Clary had the right to substitute other LT speakers if they became available and the substitution would change the price. It was agreed that in no event would the purchase price exceed $5,000. Desperate for cash, Clary wrongfully substituted much more expensive LT speakers, thereby increasing the price to $5,700. Clary then negotiated the check to Lawrence, one of his suppliers. Clary filled in the $5,700 in Lawrence's presence, showing him the shipping order and the invoice applicable to the sale to Sanders. Lawrence accepted the check in payment of $5,000 worth of overdue debts and $700 in cash. Can Lawrence recover the full amount? Why or why not?

13. GRAS is a Michigan corporation engaged in the business of buying and selling cars. Between 1997 and 2000, Katrina Stewart was employed as a manager by GRAS. During that period, Stewart wrote checks, without authority, on GRAS's corporate account payable to MBNA and sent them to MBNA for payment of her husband's MBNA credit card account. MBNA accepted the checks and credited the proceeds to Stewart's husband's credit card debt. MBNA accepted and processed the GRAS checks in its normal manner through electronic processing. When MBNA receives a check for a credit card payment, the envelope containing the check and the payment slip is opened by machine and the check and the payment slip are electronically processed and credited to the cardholder's account balance. MBNA does not normally review checks for credit card payments. After crediting a payment check to the cardholder's account, MBNA transfers it to the bank on which it is written for collection. Pursuant to its standard practice, MBNA did not review the checks it received from Stewart. GRAS did not have a customer relationship with MBNA during the relevant time period.

    GRAS sought a refund of the amounts Stewart embezzled via the MBNA application of the checks to Stewart's husband's credit card account. MBNA said it was a holder in due course. Was MBNA a holder in due course? Was MBNA subject to GRAS's defense of unauthorized instruments? [*Grand Rapids Auto Sales, Inc. v. MBNA America Bank*, 227 F. Supp. 2d 721 (W.D. Mich.)]

14. William Potts was employed by Jemoli Holdings, Inc., to liquidate assets of defunct companies. Potts had the authority to sign checks for Jemoli. Potts had a personal investment account with Raymond James Financial Services. When the stock market had its 2000 crash due to the dot-com bubble, Potts had difficulty meeting his margin calls. He began giving checks from Jemoli to Raymond James to cover the margin calls. When a representative questioned Mr. Potts about the Jemoli checks, he assured the representative that Jemoli was him, and that it was his firm. Over four months, Potts wrote checks totaling $1.5 million to Raymond James to cover loans and to make more investments. When Jemoli's principals discovered the embezzlement they brought suit to recover the funds from Raymond James. Raymond James says it was an HDC of the checks and not subject to Jemoli's claims for breach of fiduciary duty by its agent, Potts. Who is correct about the HDC status of Raymond James and why? [*Jemoli Holding, Inc. v. Raymond James Financial, Inc.*, 470 F.3d 14 (1st Cir.)]

15. Omni Trading issued two checks totaling $75,000 to Country Grain Elevators for grain it had purchased. Country Grain indorsed the checks over to the law firm of Carter & Grimsley as a retainer. Country Grain then collapsed as a business, and Omni stopped payment on the checks because all of its grain had not been delivered. Carter & Grimsley claimed it was a holder in due course and entitled to payment. However, the Department of Agriculture claimed its interest in the checks for liens and maintained that Carter & Grimsley was not a holder in due course because it had not given value.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

The trial court granted summary judgment for the Department of Agriculture because the checks were indorsed as a retainer for future legal work and Carter & Grimsley had not given value. Is Carter & Grimsley a holder in due course? [*Carter & Grimsley v. Omni Trading, Inc.*, 716 N.E.2d 320 (Ill. App.)]

CPA Questions

1. Under the Commercial Paper Article of the UCC, which of the following requirements must be met for a person to be a holder in due course of a promissory note?
   a. The note must be payable to bearer.
   b. The note must be negotiable.
   c. All prior holders must have been holders in due course.
   d. The holder must be the payee of the note.
2. A maker of a note will have a real defense against a holder in due course as a result of any of the following conditions except:
   a. Discharge in bankruptcy.
   b. Forgery.
   c. Fraud in the execution.
   d. Lack of consideration.
3. Under the commercial paper article of the UCC, in a nonconsumer transaction, which of the following are real (universal) defenses available against a holder in due course?

Material Alteration	Discharge in Bankruptcy	Breach of contract
a. No	Yes	Yes
b. Yes	Yes	No
c. No	No	Yes
d. Yes	No	No

4. A holder in due course will take free of which of the following defenses?
   a. Infancy, to the extent that it is a defense to a simple contract.
   b. Discharge of the maker in bankruptcy.
   c. A wrongful filling-in of the amount payable that was omitted from the instrument.
   d. Duress of a nature that renders the obligation of the party a nullity.
5. Mask stole one of Bloom's checks. The check was already signed by Bloom and made payable to Duval. The check was drawn on United Trust Company. Mask forged Duval's signature on the back of the check at the Corner Check Cashing Company, which in turn deposited it with its bank, Town National Bank of Toka. Town National proceeded to collect on the check from United. None of the parties mentioned were negligent. Who will bear the loss, assuming the amount cannot be recovered from Mask?
   a. Bloom
   b. Duval
   c. United Trust Company
   d. Corner Check Cashing Company
6. Robb stole one of Markum's blank checks, made it payable to himself, and forged Markum's signature to it. The check was drawn on the Unity Trust Company. Robb cashed the check at the Friendly Check Cashing Company, which in turn deposited it with its bank, Farmer's National. Farmer's National proceeded to collect on the check from Unity Trust. The theft and forgery were quickly discovered by Markum, who promptly notified Unity. None of the parties mentioned were negligent. Who will bear the loss, assuming the amount cannot be recovered from Robb?
   a. Markum
   b. Unity Trust Company
   c. Friendly Check Cashing Company
   d. Farmer's National
7. For a person to be holder in due course of a promissory note:
   a. The note must be payable in U.S. currency to the holder.
   b. The holder must be the payee of the note.
   c. The note must be negotiable.
   d. All prior holders must have been holders in due course.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CHAPTER 30

Checks and Funds Transfers

30-1 Checks

30-1a Nature of a Check
30-1b Certified Checks
30-1c Presentment for Obtaining Payment on a Check
30-1d Dishonor of a Check
30-1e The Customer-Bank Relationship
30-1f Stopping Payment of a Check
30-1g Wrongful Dishonor of a Check
30-1h Agency Status of Collecting Bank
30-1i Bank's Duty of Care

30-2 Liability of a Bank

30-2a Premature Payment of a Postdated Check
30-2b Payment over a Stop Payment Order
30-2c Payment on a Forged Signature of Drawer
30-2d Payment on a Forged or Missing Indorsement
30-2e Alteration of a Check
30-2f Unauthorized Collection of a Check
30-2g Time Limitations

30-3 Consumer Funds Transfers

30-3a Electronic Funds Transfer Act
30-3b Types of Electronic Funds Transfer Systems
30-3c Consumer Liability

30-4 Funds Transfers

30-4a What Law Governs?
30-4b Characteristics of Funds Transfers
30-4c Pattern of Funds Transfers
30-4d Scope of UCC Article 4A
30-4e Definitions
30-4f Manner of Transmitting Payment Order
30-4g Regulation by Agreement and Funds Transfer System Rules
30-4h Reimbursement of the Bank
30-4i Error in Funds Transfer
30-4j Liability for Loss

Learning Outcomes

After studying this chapter, you should be able to

LO.1 List and explain the duties of the drawee bank

LO.2 Explain the methods for, and legal effect of stopping payment

LO.3 Describe the liability of a bank for improper payment and collection

LO.4 Discuss the legal effect of forgeries and material alterations

LO.5 Specify the time limitations for reporting forgeries and alterations

LO.6 Describe the electronic transfer of funds and laws governing it

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CPA 30-1 Checks

check–order by a depositor on a bank to pay a sum of money to a payee; a bill of exchange drawn on a bank and payable on demand.

As discussed in Chapter 27, a **check** is, under Uniform Commercial Code (UCC) §3-104(f), "(i) a draft … payable on demand and drawn on a bank or (ii) a cashier's check or teller's check. An instrument may be a check even though it is described on its face by another term, such as 'money order.'"[1] The distinguishing characteristics of checks[2] and drafts are summarized in Figure 30-1. Under Article 4, the change in consumer payment patterns away from formal, signed checks is reflected with the addition of "remotely-created consumer item," which are items directing payment that are drawn on a consumer account but do not carry a handwritten signature of the drawer.[3] Consumer account is defined as a bank account used for household, family, or personal purposes.[4] These types of payments include PayPal authorizations to pay from consumer checking accounts and automatic bill payments that consumers direct via online banking.

30-1a Nature of a Check

Sufficient Funds on Deposit

As a practical matter, a check is drawn on the assumption that the bank has on deposit in the drawer's account an amount sufficient to pay the check. In the case of other drafts, there is no assumption that the drawee has any of the drawer's money with which to pay the instrument. In international transactions, sellers may require buyers not only to accept a draft agreeing to pay but also to back up that draft with a line of credit from the buyer's bank. That line of credit is the backup should the funds for the draft not be forthcoming from the buyer.

If a draft is dishonored, the drawer is civilly liable. If a check is drawn with intent to defraud the person to whom it is delivered, the drawer is also subject to criminal

FIGURE 30-1 Differences between a Check and a Draft

Check	Draft
1. Drawee is always a bank. 2. Check is drawn on assumption money is in bank to cover check. 3. Check is payable on demand. 4. Drawee bank only accepts check through certification.	1. Drawee is not necessarily a bank. 2. No assumption drawee has any of drawer's money to pay instrument. 3. Draft may be payable on demand or at future date. 4. Acceptance is required for liability of drawee.

[1] U.C.C. §3-104(f).
[2] Checks are governed by both Article 3 of the UCC and Article 4 governing bank deposits and collections. The 2001 and 2002 versions of Article 4 are covered in this chapter, along with notations of the changes since the 1990 version. The new versions of Article 4 incorporate most provisions of the American Bankers Association Bank Collection Code. The purpose of the code was to introduce clarity into the processing of millions of electronic and paper transactions that banks must handle and to recognize the reality of electronic payments.
[3] U.C.C. §3-104(16).
[4] U.C.C. §3-104(2).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

prosecution in most states. The laws under which such drawers are prosecuted are known as **bad check laws.** Most states provide that if the check is not made good within a stated period, such as 10 days, there is a presumption that the drawer originally issued the check with the intent to defraud.

bad check laws–laws making it a criminal offense to issue a bad check with intent to defraud.

CPA

Demand Paper

A draft may be payable either on demand or at a future date. A check is a form of **demand draft.** The standard form of check does not specify when it is payable, and it is therefore automatically payable on demand.

demand draft–draft that is payable upon presentment.

One exception arises when a check is **postdated**—that is, when the check shows a date later than the actual date of execution. Postdating a check means that the check is not payable until the date arrives, and it changes the check from a demand draft to a **time draft.**[5] However, banks are not obligated to hold a postdated check until the time used on the check unless the drawer has filed the appropriate paperwork with the bank for such a delay. Because of electronic processing, banks are not required to examine each instrument and honor postdated instrument requests unless the hold is placed into the bank's processing system by the customer (a stop payment order).

postdate–to insert or place on an instrument a later date than the actual date on which it was executed.

time draft–bill of exchange payable at a stated time after sight or at a definite time.

Form of the Check

A check can be in any form of writing.[6] However, bank customers may agree, as part of the contract with their bank, to use certain forms for check writing. A remotely created consumer item need only be evidenced by a *record*, not by a written document. Under Revised U.C.C. §3-104(a)(14), a *record* is defined as "information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form."[7]

Delivery Not Assignment

The delivery of a check is not an assignment of the money on deposit, so it does not automatically transfer the rights of the depositor against the bank to the holder of the check. A check written by a drawer on his drawee bank does not result in a duty on the part of the drawee bank to the holder to pay the holder the amount of the check. An ordinary check drawn on a customer's account is direction from a customer to the bank for payment, but it does not impose absolute primary liability on the bank at the time the check is written.[8]

Banks assume more responsibility for some types of checks than for the ordinary customer's check. **For Example,** a bank **money order** payable to John Jones is a check and has the bank as both the drawer and the drawee.[9] U.C.C. §3-104(g) defines a cashier's check as "a draft with respect to which the drawer and drawee are the same bank or branches of the same bank."[10] In other words, a **cashier's check** is a check or draft drawn by a bank again on itself. If a cashier's check is drawn on another bank in which the drawer bank has an account, it is a **teller's check.** Although the drawer and drawee may be the same on a money order or a cashier's check, the instrument does not lose its three-party character or its status as a check.

money order–draft issued by a bank or a nonbank.

cashier's check–draft drawn by a bank on itself.

teller's check–draft drawn by a bank on another bank in which it has an account.

[5] A bank is required to comply with a postdate on a check only if it is notified of the postdate in the same way the customer issues a stop payment order.
[6] Although not required for negotiation or presentment, a printed bank check, when the customer is using a written form, is preferable because it generally carries magnetic ink figures that facilitate sorting and posting.
[7] *Smith v. Farmers Union Mut. Ins. Co.* 260 P.3d 163 (Mont. 2011).
[8] *Sapp v. Flagstar Bank, FSB*, 12 N.E.3d 913 (Ind. App. 2014).
[9] U.C.C. §3-104(f). *Lawyer's Mut. Liability Ins. Co. of North America v. Mako*, 756 S.E.2d 809 (N.C. App. 2014).
[10] U.C.C. §3-104(g). *Golden v. Citibank, N.A.*, 23 N.Y.3d 934 (N.Y. 2014).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

substitute check– electronic image of a paper check that a bank can create and that has the same legal effect as the original instrument.

Under federal laws that Article 4 recognizes, there is another form of payments known as a **substitute check,** which is an electronic image or paper printout of an electronic image of a check. A substitute check has the same legal effect as a paper check. The bank that converts the paper check into electronic form, called the *reconverting bank*, has certain duties imposed by federal regulations to be certain that the electronic version or substitute check has all of the necessary legal information such as visible indorsements, magnetic bank code strip, payee, and signature of drawer.

30-1b Certified Checks

The drawee bank may *certify* or accept a check drawn on it. Under U.C.C. §3-409(d), a certified check is "a check accepted by the bank on which it is drawn."[11] While a bank is under no obligation to certify a check, if it does so, the certification has the effect of the bank accepting primary liability on the instrument. Check certification requires that the actual certification be written on the check and authenticated by the signature of an authorized representative of the bank.[12] Upon certification, the bank must set aside, in a special account maintained by the bank, the amount of the certified check taken from the drawer's account. The certification is a promise by the bank that when the check is presented for payment, the bank will make payment according to the terms of the check. Payment is made regardless of the status of the drawer's account at that time.

A holder or drawer may request that a check be certified by a bank. When certification is at the request of the holder, all prior indorsers and the drawer are released from liability. When certification is at the request of the drawer, the indorsers and drawer, as secondary parties, are not released. Unless otherwise agreed, the delivery of a certified check, a cashier's check, or a teller's check discharges the debt for which the check is given, up to the amount of that check.[13]

CASE SUMMARY

A Cashier's Check Is Only as Good as Its Signature

FACTS: On March 26, 2012, Dale M. Smith (defendant/counter-plaintiff) presented a cashier's check for $294,500.99 for deposit in his account with State Bank (plaintiff). The check appeared to be a cashier's check drawn on Chase bank. State Bank accepted the check for deposit. The following day, March 27, 2012, Smith requested that plaintiff wire approximately $275,000 from his account to an account in Japan. Before performing this transfer, State Bank contacted a local Chase branch and spoke to a representative. A Chase representative "confirmed the check number, the account number, verified the amount in the check and represented there were no stop-payment orders placed on the item." State Bank then processed Smith's wire transfer request.

On March 28, 2012, Chase returned the check to State Bank with the notation "refer to maker." State Bank then presented the check to Chase for payment a second time, and Chase again returned the check to State Bank. Elizabeth Roush, a Vice President and Reconciliation Manager for Chase, explained that the cashier's check was "different

[11] U.C.C. §3-409(d).

[12] Many courts treat cashier's checks and certified checks as the same because of their uniform commercial acceptability. See *Jones v. Wells Fargo Bank, N.A.*, 666 F.3d 955 (5th Cir. 2012). However, the rights of the parties are different because certification discharges all other parties to the instrument. A cashier's check does not result in the discharge of other parties on the instrument.

[13] U.C.C. §3-104(h) defines a traveler's check as "a draft drawn by a bank (i) on another bank, or (ii) payable at or through a bank."

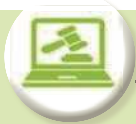
Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

A Cashier's Check Is Only as Good as Its Signature continued

from the form of official cashier's checks issued by Chase." The check number had an incorrect number of digits, did not include "a printed audit number to indicate its validity [,]" did not have the proper signature, and was missing a security symbol. At her deposition, Roush explained that only one authorized signature exists for all cashier's checks drawn on the account number printed on the cashier's check. This signature is electronically printed on all checks issued by Chase retail branches. Roush was immediately able to identify that the check was not issued by Chase because the signature was not an authorized signature for that account. Roush did not know who signed the check.

On May 16, 2012, State Bank filed suit against Smith and Chase. State Bank alleged that Chase wrongfully dishonored the check. The trial court granted summary judgment for Chase and State Bank appealed.

DECISION: The lack of a valid signature on a negotiable instrument is a real defense. The court held for Chase because the cashier's check did not have an authorized signature. An instrument is not valid unless it has a proper signature and no one is required to pay an instrument unless there is a valid signature. State Bank could not be an HDC of an instrument without a proper signature. And even if State Bank thought it was an HDC, the lack of an authorized signature is a real defense against an HDC seeking payment. Therefore, Chase was permitted to refuse payment because of a missing, authorized signature. [***State Bank v. Smith*, 85 U.C.C. Rep. Serv. 2d 260, 2014 WL 6088513 (Mich. App. 2014)**]



E-COMMERCE & CYBERLAW

The Nigerian "I Need Your Help" E-Mails

They are quite common, those e-mails that come into our accounts asking for help in transferring funds in exchange for a percentage of those funds. They only ask that they be able to use our bank accounts in the United States so that they are able to collect the money owed to them, with your 12 to 15 percent service fee for use of your account deducted.

These are scams, accomplished by simple means. The scammers do indeed have their alleged creditors furnish large checks initially to be deposited in your account. Those checks do seem to clear. They then have you write checks in the amount deposited (less your percentage fee) to them. However, subsequent problems develop with those initially deposited checks and your bank wants you to now cover the overdraft created by the scammers cashing your check. You end up owing the money to your bank. You have no claim based on forgery because it was your check. In short, the Nigerians win. There is no remedy under Article 3 or 4 for you, but there have been remedies under negligence by the banks in processing the transfers. Fraud is the easiest theory of recovery, but finding the scammers is a tall order. The federal government works tirelessly to alert people to the scams because it is nearly impossible for them to locate the scammers. Beware of e-mails coming your way from folks from Nigeria, Malaysia, and, well, any other country who wishes to use your bank account for processing their payments.

[***Anderson v. Branch Banking and Trust Co.*, 56 F. Supp. 3d 1345 (S.D. Fla. 2014)**]

CPA 30-1c Presentment for Obtaining Payment on a Check

A holder of a check must take required steps to obtain payment. As discussed in Chapter 29, there are primary and secondary parties for every negotiable instrument. Primary parties are makers and drawees. Under Article 3, secondary parties are referred to as *secondary obligors* and are defined to include "an indorser, a drawer, an accommodation party, or any other party to the instrument that has a right of recourse against another party to the instrument."[14]

[14] U.C.C. §3-104(12).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

presentment–formal request for payment on an instrument.

The process for a holder to be paid on an instrument involves mandatory steps with time limitations. The holder must first seek payment from the drawee through **presentment.** No secondary obligor is liable on an instrument until presentment has been made. Presentment is required for checks, and presentment is made first to the drawee bank.[15]

Presentment Requirements

Presentment occurs when the holder of a check or other consumer transaction authorization demands payment.[16] Under Revised Article 3, the party presents either the check or a record for payment. If the presentment is done in person, the party to whom presentment is made can require that the presenter exhibit identification. The holder who is presenting the instrument must present the check or record for payment in a commercially reasonable manner; banks can treat the transaction as having occurred the following day when presentment is made after *the close of the business day*.[17] In the case of electronic banking, banks are permitted to impose times after which posting will occur the next day. If a check is presented to the drawee bank for payment and paid, the drawer has no liability because payment has been made. (For more details on presentment, generally, of instruments, see Chapter 29.)

CPA

Time for Presentment of a Check for Payment[18]

Under the UCC, presentment must be made within a reasonable time after the drawers and indorsers have signed the check. What constitutes a reasonable time is determined by the nature of the instrument, by commercial usage, and by the facts of the particular case.

Failure to make timely presentment discharges all secondary obligors (prior indorsers) of the instrument. It also discharges the drawer to the extent that the drawer has lost, through the bank's failure, money that was on deposit at the bank to make the payment due under the check.[19]

The UCC establishes two presumptions as to what is a reasonable time for presentment of checks. If the check is not certified and is both drawn and payable within the United States, it is presumed that 90 days after the date of the check or the date of its issuance, whichever is later, is the reasonable period in which to make presentment for payment in order to attach secondary liability to the drawer.[20] With respect to attachment of the liability of an indorser, 30 days after indorsement is the presumed reasonable time.[21]

If a check is dated with the date of issue, it may be presented immediately for payment. If it is postdated, ordinarily it may not be presented until that date arrives. However, as noted earlier, the bank need not honor the date on the postdated instrument.[22] If the holder delays in making presentment, the delay discharges the drawer if the bank itself fails during such delay. If the holder of the check does not present it for payment or

[15] It is important to note that the bank is unique as a drawee because its contract as a primary party is limited by its right to dishonor a check and its right to give only provisional credit.

[16] In addition to the UCC restrictions on times for presentment, banks must comply with federally imposed time constraints. Under the Expedited Funds Availability Act, 12 U.S.C. §4001 *et seq.*, banks are required to lift provisional credits on customer accounts.

[17] U.C.C. §4-107(1). *Rogers v. Bank of America, N.A.*, 73 U.C.C. Rep. Serv. 2d 47 (S.D. Ill. 2010).

[18] U.C.C. §3-501. In re *Agriprocessors*, 490 B.R. 852 (N.D. Iowa 2013).

[19] U.C.C. §3-605.

[20] Under the previous versions of Articles 3 and 4, the time was six months.

[21] U.C.C. §3-304. *Eco-Built, Inc. v. The Nat. Bank of Indianapolis*, 683 F. Supp. 2d 892 (S.D. Ind. 2010).

[22] U.C.C. §4-208(c).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

collection within 90 days after an indorsement was made, the secondary obligors (indorsers) are discharged from liability to the extent that the drawer has lost, through the bank's failure, money that was on deposit at the bank to meet the payment under the check.

Under Articles 3 and 4, agreeing to honor an instrument beyond this time limit changes the obligation of the primary obligor and, as a result, changes the obligation of the secondary obligors. Such changes in the terms and conditions of payment serve to discharge the secondary obligors, a change that brings UCC Articles 3 and 4 in line with the principles of surety law (see Chapter 32).

A bank may continue to honor checks presented for payment after the 90-day period, but it does so with understanding of the discharge of liability for the primary and secondary obligors. A bank honoring a check that is overdue subjects the bank to questions about whether it exercised good faith and reasonable care in honoring it.[23]

30-1d Dishonor of a Check

If the bank refuses to make payment, the drawer is then subject to the same secondary liability as the drawer of an ordinary draft.[24] To be able to attach that secondary liability, the holder of the instrument must notify the drawer of the dishonor by the drawee. The notice of dishonor may be oral, written, or electronic.

CPA Time for Notice of Dishonor

Banks in the chain of collection for a check must give notice of dishonor by midnight of the next banking day.[25] Others, including the payee or holder of the check, must give notice of dishonor within 30 days after learning that the instrument has been dishonored. If proper notice of dishonor is not given to the drawer of the check, the drawer will be discharged from liability to the same extent as the drawer of an ordinary draft.[26]

CPA Overdraft

overdraft–negative balance in a drawer's account.

If the bank pays the check but the funds in the account are not sufficient to cover the amount, the excess of the payment over the amount on deposit is an **overdraft.** This overdraft is treated as a loan from the bank to the customer, and the customer must repay that amount to the bank.

If the bank account from which the check is drawn is one held by two or more persons, the joint account holder who does not sign the check that creates an overdraft is not liable for the amount of the overdraft if she received no benefit from the proceeds of that check.[27] Additional issues on overdrafts and dishonor of checks are covered in the next section, "The Customer-Bank Relationship."

[23] Article 3 changed the "negligence" of the bank to the "failure to exercise ordinary are" in §3-406. A bank need not pay a check that is presented to it after 90 days (the presumptive ordinary care period) from the date of issue (except for certified checks), but it can honor such a check and charge the customer's account if it does so in good faith.

[24] U.C.C. §3-414. PayPal is not considered a bank for purposes of Articles 3 and 4. *Zepeda v. PayPal Inc.*, 777 F. Supp. 2d 1215 (N.D. Cal. 2011).

[25] The former time frame for nonbanks was midnight of the third business day. *Troy Bank and Trust Co. v. Citizens Bank*, 166 So. 3d 57 (Ala. 2014).

[26] U.C.C. §4-213. Under Federal Reserve regulations, notice of dishonor may be given by telephone. *Security Bank and Trust Co. v. Federal Nat'l Bank*, 554 P.2d 119 (Okla. Ct. App. 1976). But it must be an official notice of dishonor and not notice that there is a problem with the check prior to it being presented for payment. *City Check Cashing, Inc. v. Manufacturers Hanover Trust Co.*, 764 A.2d 411, 43 U.C.C. Rep. Serv. 2d 768 (N.J. 2001).

[27] U.C.C. §§4-214 and 4-401(b). *Sapp v. Flagstar Bank, FSB*, 12 N.E.3d 913 (Ind. App. 2014).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

ETHICS & THE LAW

Getting Hit for SOOO Many Overdraft Fees

On August 28, 2008, Cortney Hassler had a balance of $112.35 in his checking account. He made a $39.58 payment in the morning and a $140.00 debit in the afternoon. Sovereign Bank did not post the transactions in the order that they occurred but, rather, rearranged the debits so that Cortney had to pay two $33 overdraft fees on his account. A provision in his checking account agreement indicated that Sovereign had the right to pay the withdrawals in any order. Cortney filed a class-action suit against the bank for unfair trade practices and unjust enrichment.

Evaluate the legal rights of the bank to post the transactions as it did. Evaluate the ethical issues in the changes in posting order so as to maximize the overdraft fees.

[*Lunsford v. Woodforest Nat. Bank*, 299 F.R.D. 695 (N.D. Ga. 2013)]

30-1e The Customer-Bank Relationship

The relationship between banks and customers is governed by Articles 3 and 4 of the UCC as well as by several federal statutes. These laws impose duties and liabilities on both banks and customers.

Privacy

The bank owes its customer the duty of maintaining the privacy of the information that the bank acquires in connection with its relationship with the customer. Law enforcement officers and administrative agencies cannot require the disclosure of information relating to a customer's account without first obtaining the customer's consent or a search warrant or without following the statutory procedures designed to protect customers from unreasonable invasions of privacy.[28] The **USA Patriot Act** does impose certain reporting requirements on banks, financial institutions, and businesses with regard to deposits of cash and large cash payments. These reporting requirements were imposed to be able to track money laundering efforts as well as possible funding of terrorist activities.[29] For example, checks that involve amounts of more than $10,000 generally trigger the bank reporting systems under the USA Patriot Act.

USA Patriot Act–federal law that, among other things, imposes reporting requirements on banks.

With the advent of the Internet and other electronic exchanges of information, it has become much easier for businesses, including banks, to exchange information about customers. All businesses are subject to federal constraints on the use of customer information. (See Chapter 32 for more information.)

Payment

A bank is under a general contractual duty to its customers to pay on demand all checks to the extent of the funds in a depositor's account.

CPA

Stale Checks. A bank is under no obligation to a customer to pay a check (other than one that is certified) that is presented for payment more than six months after its date. This type of check is commonly called a **stale check.**[30] However, if a bank acts in good faith, it can charge a customer's account for a check that is older than six months. Establishing that "good faith" is an uphill battle, so most banks will not cash a stale check unless and until it has verified such with its customer. Regardless of the date of the check, banks are always under an obligation to use good faith and commercial reasonableness in processing all checks.

stale check–a check whose date is longer than six months ago.

[28] Right to Financial Privacy Act of 1978, 12 U.S.C. §3401 *et seq.*
[29] 12 U.S.C. §5311 *et seq.* 2001.
[30] U.C.C. §§3-304 and 4-404; *Commerce Bank, N.A. v. Rickett*, 748 A.2d 111 (N.J. Super. 2000).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Do not confuse the six-month stale check rule with the 90-days overdue instrument rule. The 90-day rule in Section 3-304 is the timing provision for an HDC to take a check in good faith and without notice that it is overdue. Ninety days is not the measurement for bank processing of a customer's check and six months is not the time limit for taking as an HDC. There are two separate time frames here for two different issues.

Payment after Depositor's Death. From the time of death, the bank can continue paying items until it actually knows of the customer's death.[31] The bank has the right, even with notice of the death, to continue to pay items for 10 days unless, for example, an heir or a government agency halts the payments.[32]

CPA

30-1f Stopping Payment of a Check

stop payment order–order by a depositor to the bank to refuse to make payment of a check when presented for payment.

A drawer may stop payment of a check by notifying the drawee bank in the required manner.[33] **Stop payment orders** are often used when a check is lost or mislaid. The drawer can always write a duplicate check but wants assurance that the original lost or misplaced check will not then also be presented for payment. The drawer can stop payment on the first check to prevent double-dipping. A drawer can also use a stop payment order on a check if the payee has not kept his end of the contract or has failed to provide assurances (see Chapter 25). However, the drawer must keep in mind that if a holder in due course has the check, the holder in due course can demand payment because she would not be subject to the personal defenses of breach of contract or nonperformance of contract. (See Chapter 29 and the rights of holders in due course.)

Stop payment orders are invalid for some forms of checks even when properly executed. Neither the drawer nor a bank customer can stop payment of a **certified check.** A bank customer cannot stop payment of a cashier's check.

CPA

Form of Stop Payment Order

certified check–check for which the bank has set aside in a special account sufficient funds to pay it; payment is made when check is presented regardless of amount in drawer's account at that time; discharges all parties except certifying bank when holder requests certification.

The stop payment order may be either oral or by record (written or evidence of electronic order). If oral, however, the order is binding on the bank for only 14 calendar days unless confirmed in writing within that time. A record of the stop payment order or confirmation is effective for six months. A stop payment order can be renewed for an additional six months if the customer provides the bank a written extension.

Liability to Holder for Stopping Payment

The act of stopping payment may in some cases make the drawer liable to the holder of the check. If the drawer has no proper ground for stopping payment, the drawer is liable to the holder of the check. In any case, the drawer is liable for stopping payment with respect to any holder in due course or any other party having the rights of a holder in due course unless payment was stopped for a reason that may be asserted as a defense against a holder in due course (see Chapter 29). The fact that payment of a check has been stopped does not affect its negotiable character.[34]

30-1g Wrongful Dishonor of a Check

wrongfully dishonored–error by a bank in refusing to pay a check.

A check is **wrongfully dishonored** by the drawee bank if the bank refuses to pay the amount of the check although (1) it is properly payable and (2) the account on which it is drawn is sufficient to pay the item. Dishonor for lack of funds can be a breach of contract if the customer has an agreement with the bank that it will pay overdraft items.

[31] U.C.C. §4-405(2).
[32] U.C.C. §4-405(b); *Hieber v. Uptown Nat'l Bank of Chicago*, 557 N.E.2d 408 (Ill. App. 1990).
[33] U.C.C. §4-403.
[34] *Aliaga Medical Center, S.C. v. Harris Bank N.A.*, 21 N.E.3d 1203 (Ill. App. 2014).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Bank's Liability to Drawer of Check

CPA

If the bank improperly refuses to make payment, it is liable to the drawer for damages sustained by the drawer as a consequence of such dishonor.

Bank's Liability to Holder

If a check has not been certified, the holder has no claim against the bank for the dishonor of the check regardless of the fact that the bank was wrong in its dishonor. The bank that certifies a check is liable to the holder when it dishonors the check.

Holder's Notice of Dishonor of Check

When a check is dishonored by nonpayment, the holder must follow the procedure for notice to the secondary parties. Notice of dishonor need not be given to the drawer who has stopped payment on a check or to drawers and indorsers who are aware that there are insufficient funds on deposit to cover the check. In those circumstances, no party has reason to expect that the check will be paid by the bank.

30-1h Agency Status of Collecting Bank

agent–person or firm who is authorized by the principal or by operation of law to make contracts with third persons on behalf of the principal.

agency–the relationship that exists between a person identified as a principal and another by virtue of which the latter may make contracts with third persons on behalf of the principal. (Parties–principal, agent, third person)

When a customer deposits negotiable instruments in a bank, the bank is regarded as being merely an **agent,** even though the customer may be given the right to make immediate withdrawals against the deposited item. Because of the bank's **agency** status, the customer remains the owner of the item and is subject to the risks of ownership involved in its collection.

When a bank cashes a check deposited by its customer or cashes a check drawn by its customer based on an amount from a deposited check, it is a holder of the check deposited by its customer. The bank may still collect from the parties on the check even though the bank is an agent for collection and has the right to charge back the amount of the deposited check if it cannot be collected.

30-1i Bank's Duty of Care

A bank is required to exercise ordinary care in the handling of items. The liability of a bank is determined by the law of the state where the bank, branch, or separate office involved is located.

Modification of Bank Duties

CPA

The parties in the bank collection process may modify their rights and duties by agreement. However, a bank cannot disclaim liability for lack of good faith or failure to exercise ordinary care, nor can it limit the measure of damages for such lack of care.

When a bank handles checks by automated processes, the bank must use the ordinary standard of care of the industry and that standard of ordinary care does not require the bank to make a physical examination of each item.

Encoding Warranty and Electronic Presentment

encoding warranty–warranty made by any party who encodes electronic information on an instrument; a warranty of accuracy.

In addition to transfer and presentment warranties, an **encoding warranty** is also given by those who transfer instruments. Under this warranty, anyone placing information on an item or transmitting the information electronically warrants that the information is correct. When there is an agreement for electronic presentment, the presenter warrants that the transfer is made properly for transmissions.[35]

[35] U.C.C. §§4-207 to 4-209.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Counterfeit Checks

One of the problems that banks now experience is the use of counterfeit checks. Because of automated processing, these checks can sail through bank systems and seemingly are cleared. Customers, in reliance on the check clearing, use those funds only to be told later that the check was a counterfeit and the funds credited to their account are then debited. The liability for the losses resulting from counterfeit checks will depend on whether the bank acted reasonably in its processing systems in clearing checks (particularly those for large amounts) and whether it complied with the time requirements for notifying customers of a dishonor of a deposited counterfeit check.

CASE SUMMARY

The Lawyers Who Got Taken by Their Counterfeit Clients

FACTS: Greenberg, Trager & Herbst, LLP (GTH), is a law firm specializing in construction litigation law. In September 2007, a partner at GTH received an e-mail from a representative of Northlink Industrial Limited, a Hong Kong company. Northlink was looking for legal representation to assist it in the collection of debts owed by its North American customers. Through a series of e-mails GTH agreed to represent Northlink and requested a $10,000 retainer. GTH then received a Citibank check for $197,750 from a Northlink customer and was told that it could take its retainer from those funds. On Friday, September 21, 2007, GTH deposited the check into its account at HSBC.

The next business day, Monday, September 24, HSBC processed the check through the Federal Reserve Bank of Philadelphia (FRBP) and, because of the federal funds availability law, provisionally credited GTH's account for $197,750. FRBP presented an image replacement document (IRD) of the check to Citibank that same day.

Because the routing number was not recognized by Citi's processing system, the automated sorting system directed the IRD to the reject pocket.

HSBC received the IRD with the notation "sent wrong" the next day, September 25, 2007. Because the check was marked "sent wrong," HSBC assumed that there was a problem with the routing number that required sending the check to a different Federal Reserve bank. On September 26, 2007, HSBC sent the check to the Federal Reserve Bank, San Francisco (FRBS). HSBC never informed GTH of the "administrative return" of the check.

On September 27, 2007, a GTH partner called HSBC to determine whether the check had "cleared" and if the funds were available for disbursement. GTH was informed that the funds were available. Later that day, GTH wired $187,750 from its account to Hong Kong as Northlink instructed.

On October 2, 2007, HSBC received Citibank's notice that the check was being dishonored as "RTM [return to maker] Suspect Counterfeit." HSBC contacted GTH to inform them that the check had been dishonored. HSBC then revoked its provisional settlement and charged back GTH's account.

GTH filed suit against HSBC and Citibank for failure to inform GTH that the check had been returned and dishonored on September 25 and for informing GTH over the phone that the funds had "cleared" and were available for disbursement. HSBC and Citibank moved for summary judgment.

The trial court found that HSBC had no duty under the UCC to inform GTH that the check had been returned "sent wrong" on September 25, but rather that the dishonor actually took place when HSBC discovered that the check was "Suspect Counterfeit," and dismissed the complaint.

DECISION: The bank did not owe duty to GTH to have effective procedures in place to detect counterfeit checks. The bank is only required to present the check for payment to the drawee bank, and the drawee bank and its customer are charged with the duty of monitoring properly payable items. The bank's alleged oral statement that the check had "cleared" and the funds were available for transfer was not a misrepresentation because banking rules do not allow reliance on oral representations. A check is not cleared until it actually goes through the banking system. The bank exercised ordinary care in handling the check and did not breach any duty to GTH and its alleged oral representations could not be a basis for GTH's reliance. [***Greenberg, Trager & Herbst, LLP v. HSBC Bank USA*, 934 N.Y.S.2d 43 75 U.C.C. Rep. Serv. 2d 775 (Sup. Ct. 2011)**]

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

CPA 30-2 Liability of a Bank

Banks can make mistakes in the payment and collection of items presented to them by their customers. **For Example,** a check may slip through and be cashed over a customer's properly executed stop payment order. The bank would be liable for this improper payment and may also be liable for improperly collecting, paying, or refusing to pay a check.

30-2a Premature Payment of a Postdated Check

A check may be postdated, but the bank is not liable for making payments on the check before the date stated unless the drawer has given the bank prior notice. Such a notice is similar to a stop payment order; it must provide sufficient information so that the bank is moved to action by the trigger that comes from the orderly processing of the check as it flows through its electronic processing system.[36]

30-2b Payment over a Stop Payment Order

A bank must be given a reasonable time in which to put a stop payment order into effect. However, if the bank makes payment of a check after it has been properly notified to stop payment, and there has been sufficient time for the order to be put into the system, the bank is liable to the drawer (customer) for the loss the drawer sustains in the absence of a valid limitation of the bank's liability.[37] The bank must have complete information on a stop payment order, such as the payee, check number, and amount, to be held responsible for the failure to stop payment.

CASE SUMMARY

When Writing "Stop" Is Not Enough to Halt a Check

FACTS: Aliaga Medical Center first opened a business checking account with Harris Bank in December 2003. Upon opening the account, Aliaga acknowledged that it received the "Harris Bank Handbook for Personal and Business Deposit Accounts." The first page of the handbook included the statement that the customer "agree[s] to the terms of this Agreement when [Aliaga] sign[s] [Harris Bank's] account opening form or signature card, make[s] deposits or withdrawals, or leave[s] funds on deposit."

The handbook also required that if Aliaga wanted to stop payment on a check it had written, the following requirements would apply:

> *If you do not want us to pay a check you have written, you can order us to stop payment. Your stop payment order must include your account number, the number and date of the check, the name of the payee, and the amount. We must receive your stop payment order before our stop payment cut-off time, which is 10 a.m. Central Time (C.T.) on the next Business Day after the check is presented to us for payment. We will accept a stop payment order from any account owner regardless of who signed the check. Your stop payment order will be effective for six months. If you want the stop payment order to continue after six months, you must renew it.*

Under the agreement, Harris Bank specifically "reserve[d] [its] right to pay * * * a stale check."

The agreement contained a number of other relevant notification provisions, including notice provisions that required customers to notify the Bank of any issues or problems with its account within 60 days of receiving a statement and that suit must be filed within one year of receiving the statement.

[36] Note that a "postdated check" is not a check but a time draft. U.C.C. §§4401 to 4-402.
[37] U.C.C. §4-403(c); *Lombino v. Bank of America, N.A.*, 797 F. Supp. 2d 1078 (D. Nev. 2011).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

When Writing "Stop" Is Not Enough to Halt a Check continued

On July 10, 2010, Dr. Federico Aliaga, the plaintiff's president, issued a check in the amount of $50,000 (the check), payable to his wife, whom he was divorcing. The face of the check included the statement "void after 90 days" immediately above the signature line. Harris Bank honored the check on December 30, 2010. Aliaga never placed a stop payment order on the check, and, in fact, never communicated with Harris about the check anytime between July 10, 2010, and December 30, 2010.

In January 2011, Harris Bank sent and made available to Aliaga its December 2010 checking account statement, which showed that Harris Bank had honored the check on December 30, 2010. Aliaga, however, did not notify Harris Bank of the improper check payment within the 60-day notification period delineated in the parties' agreement. Additionally, Aliaga did not initiate this lawsuit within one year of the date Harris Bank sent or made available the December 2010 statement. Instead, Aliaga waited until October or November 2012, nearly two years after the December 2010 statement was made available, before disputing the check with Harris.

Harris moved to dismiss the complaint. The trial court granted the motion, and Aliaga appealed.

DECISION: Harris had the right to pay the check despite the "void after 90 days" language because Aliaga failed to properly stop payment of the check. Under the parties' agreement, if Aliaga did not want Harris Bank to pay a check it had written, then Aliaga had to comply with certain requirements.

Aliaga claims that under a UCC provision (810 ILCS 5/4–403(a) (West 2012)), it was only required to stop payment "in a time and manner that gives the bank a reasonable opportunity to comply" and that its notation on the check "certainly achieves this." However, Aliaga's contention is without merit for several reasons. First, the UCC permits that "[t]he effect of [its] provisions * * * may be varied by agreement."

Furthermore, even if Aliaga is correct that the stop payment provision of the agreement was neither exclusive nor meant to override the UCC, the "void" notation was ineffective because it did not comply with section 4–403(a) of the UCC by providing notice "at a time and in a manner that affords the bank a reasonable opportunity to act on it."

Aliaga also failed to comply with its obligation to timely notify Harris Bank of the alleged unauthorized payment of the check within 60 days after Harris Bank made Aliaga's December 2010 statement available to it.

Aliaga admitted that it did not comply with these terms of the agreement by providing timely notice to Harris Bank within 60 days of the date that it sent, or otherwise made available to Aliaga, the December 2010 statement. Aliaga further conceded that it did not contact Harris Bank about the payment within 60 days of receiving the December 2010 statement. As a result, Aliaga's claim is untimely.

Finally, Aliaga failed to timely commence this lawsuit within one year from the date that Harris Bank sent or made available the December 2010 statement.

Affirmed. **[*Aliaga Medical Center, S.C. v. Harris Bank N.A.*, 21 N.E.3d 1203 (Ill. App. 2014)]**

CPA 30-2c Payment on a Forged Signature of Drawer

A forgery of the signature of the drawer occurs when the name of the drawer has been signed by another person without authority to do so with the intent to defraud by making it appear that the drawer signed the check. The bank is liable to the drawer if it pays a check on which the drawer's signature has been forged because a forgery ordinarily has no effect as a signature. The risk of loss caused by the forged signature of the drawer is placed on the bank without regard to whether the bank could have detected the forgery.[38] The reasoning behind the bank's liability for a forged drawer's signature is that the bank is presumed to know its own customers' signatures even if it does not regularly review checks for authenticity of the signature.

A bank's customer whose signature has been forged may be barred from holding the bank liable if the customer's negligence substantially contributed to the making of the forgery. This preclusion rule prevents or precludes the customer from making a forgery

[38] *Du v. Bank of America, N.A.* Not Reported in N.E.2d, 30 Mass. L. Rptr. 337, 2012 WL 5362292 (Mass. Super. 2012). Some states allow for an action for conversion of funds by the customer. *300 Broadway Healthcare Center, LLC v. Wachovia Bank, N.A.*, 39 A.3d 248 (N.J. App. 2012), but see *DMDB Adults, Inc. v. Bank of America Corp.*, 951 N.Y.S.2d 492 (N.Y.A.D. 2012).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

claim against the bank. However, to enjoy the protection of the preclusion rule, the bank, if negligent in its failure to detect the forgery or alteration, must have cashed the check in good faith or have taken it for value or collection.[39]

Article 4 of the UCC extends forgery protections and rights to alterations and unauthorized signings. When an officer with authority limited to signing $5,000 checks signs a check for $7,500, the signature is unauthorized. If the principal for the drawer account is an organization and has a requirement that two or more designated persons sign negotiable instruments on its behalf, signatures by fewer than the specified number are also classified as unauthorized signatures.

CPA

30-2d Payment on a Forged or Missing Indorsement

A drawee bank that honors a customer's check bearing a forged indorsement must recredit the customer's account upon the drawer's discovery of the forgery and notification to the bank. A drawee bank is liable for the loss when it pays a check that lacks an essential indorsement.[40] In such a case, the instrument is not properly payable. Without proper indorsements for an order instrument and special indorsements, the person presenting the check for payment is not the holder of the instrument and is not entitled to demand or receive payment. However, the bank can then turn to the indorsers and transferors of the instrument for breach of warranty liability in that all signatures were not genuine or authorized and they did not have title. All transferors can turn to their previous transferor until liability ultimately rests with the party who first accepted the forged indorsement. This party had face-to-face contact and could have verified signatures.[41]

When a customer deposits a check but does not indorse it, the customer's bank may make an indorsement on behalf of the depositor unless the check expressly requires the customer's indorsement. A bank cannot add the missing indorsement of a person who is not its customer when an item payable is deposited in a customer's bank account.

30-2e Alteration of a Check

If the face of a check has been altered so that the amount to be paid has been increased, the bank is liable to the drawer for the amount of the increase when it makes payment of the greater amount.

The drawer may be barred from claiming that there was an alteration if there was negligence in writing the check or reporting its alteration. A drawer is barred from claiming alteration if the check was written negligently, the negligence substantially contributed to the making of the material alteration, and the bank honored the check in good faith and observed reasonable commercial standards in doing so. **For Example,** the drawer is barred from claiming alteration when the check was written with blank spaces that readily permitted a change of "four" to "four hundred" and the drawee bank paid out the latter sum because the alteration was not obvious. A careful drawer will write figures and words close together and run a line through or cross out any blank spaces.

30-2f Unauthorized Collection of a Check

A collecting bank, or a bank simply collecting an item for a customer, is protected from liability when it follows its customer's instructions. It is not required to inquire or verify

[39] U.C.C. §4-406(e); *Citizens Bank of Pennsylvania v. Reimbursement Technologies, Inc.*, 2014 WL 2738220 (E.D. Pa. 2014); *Rodgeres v. Bank of America, N.A.*, 73 U.C.C. Rep. Serv. 2d 47 (S.D. Ill. 2011).

[40] *Simi Management Corp. v. Bank of America, N.A.*, 930 F. Supp. 2d 1082 (N.D. Cal. 2013); *VIP Mortg. Corp. v. Bank of America, N.A.*, 769 F. Supp. 2d 20 (D. Mass. 2011).

[41] *Smith v. Farmers Union Mut. Ins. Co.*, 260 P.3d 163 (Mont. 2011).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

that the customer had the authority to give such instructions. In contrast, instructions do not protect a payor bank. It has an absolute duty to make proper payment. If it does not do so, it is liable unless it is protected by estoppel or by the preclusion rule. The person giving wrongful instructions is liable for the loss caused by those instructions.

CASE SUMMARY

The Devil Shops at Neiman Marcus Using Her Boss's Checks

FACTS: Carol Young was employed as Brian P. Burns's secretary at a salary that never exceeded $75,000. Between 1995 and 2000, Young opened several credit card accounts with Neiman Marcus. In the three-year period prior to 2006, Young spent approximately $1 million at Neiman Marcus, and "the balance on [one] credit card, as of January 10, 2006, was in excess of $242,000." Young was offered entrée into Neiman Marcus's exclusive INCIRCLE® rewards program—a loyalty incentive program. Young had a personal shopper who knew of her annual salary of less than $75,000. However, the personal shopper repeatedly contacted and encouraged Young to make excessive purchases with her various Neiman Marcus cards.

Young would personally deliver on a regular basis fraudulent and forged checks drawn on Burns's Union Bank of California checking account to pay down her various [Neiman Marcus] credit card bills at the Customer Service Center in Neiman's San Francisco store. Young used three different methods for presenting Burns's checks: (a) stealing checks and forging Burns's signature; (b) stealing checks with no signature whatsoever; and (c) stealing checks with Burns's signature—checks that Burns presumed were for payments toward his own Neiman Marcus credit card account, but which were diverted to Young's credit card accounts.

Because Young managed all of Burns's accounts, the reconciliations she made had fake ledger entries for payment to third parties to cover her payments to Neiman Marcus. Burns did not detect Young's activities for three years because he did not see the bank statements, only Young did. A serendipitous examination of the ledger and canceled checks resulted in the discovery. Burns recovered what he could from his bank, an amount limited by UCC Article 4. Burns filed suit against Neiman Marcus, seeking to recover the funds paid on the checks and claiming that Neiman Marcus was subject to the defenses of forgery and unauthorized payments. The trial court granted Neiman Marcus's motion for demurrer and Burns appealed.

DECISION: The court affirmed the lower court's dismissal because it was unwilling to impose a broad duty on third parties to verify that every third-party check it receives is legitimate. Such a requirement would significantly slow down the flow and use of negotiable instruments and defeat both the purposes of Articles 3 and 4 as well as the well-defined rules for responsibility and liability when there are drawer and drawee forgeries. **[*Burns v. Neiman Marcus Group, Inc.*, 173 Cal. App. 4th 479 (Cal. App. 1st Dist. 2009)]**

30-2g Time Limitations

The liability of the bank to its depositor is subject to certain time limitations.

CPA Forgery and Alteration Reporting Time

A customer must examine with reasonable care and promptness a bank statement and relevant checks that are paid in good faith and sent to the customer by the bank and must try to discover any unauthorized signature or alteration on the checks. The customer must notify the bank promptly after discovering either a forgery or an alteration. If the bank exercises ordinary care in paying a forged or an altered check and suffers a loss because the customer fails to discover and notify the bank of the forgery or alteration, the customer cannot assert the unauthorized signature or alteration against the bank.[42]

[42] *Crawford Supply Group, Inc. v. Bank of America, N.A.*, 2011 WL 1131292 (N.D. Ill. 2011).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Under the Check Truncation Act (CTA—which is part of the Check 21 statute covered in Chapter 27), banks now have the right to substitute electronic images of checks for customer billing statements. The CTA is largely implemented through Federal Reserve Board regulations found at 12 CFR §229.2. Banks do not need to provide the original check to their customers and can simply send copies of electronic images so long as the image provides enough clarity for the customer to see payee, encoding, indorsements, and so on.

With the use of substituted checks and online banking, consumers now have additional rights and time limits with substituted checks. Under the Check 21 statute, consumers have a new right to an expedited recredit to their account if a substitute check was charged improperly to their account. They have the right to see the original check if they can explain why it is necessary and that they are suffering a loss as a result of the improper charge of a substitute check to their account. Consumers have 40 calendar days from whichever of the following is later: (1) the delivery of their monthly bank statements or (2) that date on which the substitute check was made available to them for examination and/or review. If a consumer has been traveling or has been ill, the rules permit the extension of the deadline to challenge a substitute check. Consumers can even call their bank and challenge a payment, but they will not then get the benefit of all the rights and protections under Check 21 and its regulations if they choose to proceed without a written demand on a substitute check.[43] Once the demand is made, the bank must either recredit the consumer's account within one business day or explain why it believes the substitute check was charged properly to the consumer's account. The oral demand does not start this clock running for the consumer's protection. There are also fines and overdraft protections provided while the substitute check issue is in the dispute/investigation stage.

Some cases of forgery are the result of a customer's lack of care, such as when an employee is given too much authority and internal controls are lacking with the result that the employee is able to forge checks on a regular basis not easily detected by the bank. Referred to as the *fictitious payee and impostor exceptions*, this issue was covered in Chapter 28.

Customers are precluded from asserting unauthorized signatures or alterations if they do not report them within one year from the time the bank statement is received.[44] A forged indorsement must be reported within three years.

Unauthorized Signature or Alteration by Same Wrongdoer

If there is a series of improperly paid items and the same wrongdoer is involved, the customer is protected only as to those items that were paid by the bank before it received notification from the customer and during that reasonable amount of time that the customer has to examine items or statements and to notify the bank. If the customer failed to exercise reasonable promptness and failed to notify the bank but the customer can show that the bank failed to exercise ordinary care in paying the items, the loss will be allocated between the customer and the bank.[45]

Statute of Limitations

An action to enforce a liability imposed by Article 4 must be commenced within three years after the cause of action accrued.

[43] 12 C.F.R. 229.54(b)(1)(iii).
[44] U.C.C. §4-406.
[45] U.C.C. §4-406 (2012); *HH Computer Systems, Inc. v. Pacific City Bank*, 179 Cal. Rptr. 689 (Cal. App. 2014).

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

THINKING THINGS THROUGH

The Business Law Professor with the Lost Cashier's Check

Marianne Jennings obtained a cashier's check in order to pay off her car loan in the amount of $37,000. Professor Jennings mailed the cashier's check via Express Mail, requiring signature. An employee at the lender (an automaker financial arm) received the check and felt that because it did not have the signature of "Marianne Jennings" on it that it was invalid. The employee sent the check back to Professor Jennings via regular U.S. mail.

Professor Jennings, having received proof of receipt on the check, did not make her next car payment. She then received a notice of an overdue payment, a penalty for late payment, and that her late payment had been reported to the credit bureau.

Professor Jennings contacted the lender and was told that the check had been returned, and the late penalty would stand. Professor Jennings then went to the bank to discuss options. The bank indicated that it could issue a stop payment order if Professor Jennings would pay for a bond in the amount of $37,000, which would run about $1,200. The bank indicated that it could not issue a stop payment and that the cashier's check had been properly issued.

Discuss for Professor Jennings her rights in this situation, including any possible solutions to the situation. The cashier's check was never found. Also, be sure to discuss liability issues regarding the late payment, penalties, and effect on her credit rating.

30-3 Consumer Funds Transfers

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 federal statute protects consumers making electronic funds transfers.

30-3a Electronic Funds Transfer Act

Electronic Funds Transfer Act (EFTA)–federal law that provides consumers with rights and protections in electronic funds transfers.

electronic funds transfer (EFT)–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.

Congress passed the **Electronic Funds Transfer Act (EFTA)** to protect consumers making electronic transfers of funds.[46] **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.[47]

30-3b Types of Electronic Funds Transfer Systems

Currently, five common types of EFT systems are in use. In some of these systems, the consumer has a card to access a machine. The consumer usually has a private code that prevents others who wrongfully obtain the card from using it.

Automated Teller Machine

The *automated teller machine (ATM)* performs many of the tasks once performed exclusively by bank employees. Once a user activates an ATM, he can deposit and withdraw funds from his account, transfer funds between accounts, make payments on loan accounts, and obtain cash advances from bank credit cards.

[46] 15 U.S.C. §1693 *et seq.*
[47] The majority of the states have adopted the 1990 version of Article 4A.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Pay-by-Phone System

This system facilitates paying telephone, mortgage, utility, and other bills without writing checks. The consumer calls the bank and directs the transfer of funds to a designated third party.

Direct Deposit and Withdrawal

Employees may authorize their employers to deposit wages directly to their accounts. A consumer who has just purchased an automobile on credit may elect to have monthly payments withdrawn from a bank account to be paid directly to the seller.

Point-of-Sale Terminal

The *point-of-sale terminal* allows a business with such a terminal to transfer funds from a consumer's account to the store's account. The consumer must be furnished in advance with the terms and conditions of all EFT services and must be given periodic statements covering account activity. Any automatic EFT from an individual's account must be authorized in writing in advance.

Financial institutions are liable to consumers for all damages proximately caused by the failure to make an EFT in accordance with the terms and conditions of an account. Exceptions include insufficient funds, funds subject to legal process, exceeding an established credit limit, or insufficient cash is available in an ATM.

Internet Banking

Internet banking is the customer use of computer access to bank systems to pay bills, balance accounts, transfer funds, and even obtain loans. Increasing in popularity, this form of banking still suffers from concerns about privacy and security. However, the revisions to Articles 3 and 4 recognize electronic records as valid proof of payment.

CPA 30-3c Consumer Liability

A consumer who notifies the issuer of an EFT card within two days after learning of a loss or theft of the card can be held to a maximum liability of $50 for unauthorized use of the card. If you report the loss before the card is used, you have no liability. Failure to notify within this time (after 2 days but before 60 days) will increase the consumer's liability for losses to a maximum of $500. After 60 days, you have unlimited liability. However, by the end of 60 days, you will have been through at least two monthly statements and will have had every opportunity to provide notification. Consumers have the responsibility to examine periodic statements provided by their financial institution.

CPA 30-4 Funds Transfers

The funds transfers made by businesses are governed by the UCC and Federal Reserve regulations.

30-4a What Law Governs?

In states that have adopted Article 4A of the Uniform Commercial Code, that article governs funds transfers. In addition, whenever a Federal Reserve Bank is involved, the provisions of Article 4A apply by virtue of Federal Reserve regulations.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

30-4b Characteristics of Funds Transfers

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 a business day can amount to trillions of dollars.

30-4c Pattern of Funds Transfers

In the simplest form of funds transfer, both the debtor and the creditor have separate accounts in the same bank.[48] In this situation, the debtor can instruct the bank to pay the creditor a specified sum of money by subtracting that amount from the debtor's account and adding it to the creditor's account. As a practical matter, the debtor merely instructs the bank to make the transfer.

A more complex situation is involved if each party has an account in a different bank. In that case, the funds transfer could involve only these two banks and no clearinghouse. The buyer can instruct the buyer's bank to direct the seller's bank to make payment to the seller. There is direct communication between the two banks. In a more complex situation, the buyer's bank may relay the payment order to another bank, called an **intermediary bank,** and that bank, in turn, transmits the payment order to the seller's bank. Such transactions become even more complex when two or more intermediary banks or a clearinghouse is involved.

intermediary bank–bank between the originator and the beneficiary bank in the transfer of funds.

30-4d Scope of UCC Article 4A

Article 4A applies to all funds transfers except as expressly excluded because of their nature or because of the parties involved.

EFTA and Consumer Transactions

Article 4A does not apply to consumer transaction payments to which the EFTA applies. If any part of the funds transfer is subject to the EFTA, the entire transfer is expressly excluded from the scope of UCC Article 4A.[49]

Credit and Debit Transfers

When the person making payment, such as the buyer, requests that payment be made to the beneficiary's bank, the transaction is called a **credit transfer.** If the beneficiary entitled to money goes to the bank according to a prior agreement and requests payment, the transaction is called a **debit transfer.** The latter transfer type is not regulated by Article 4A. Article 4A applies only to transfers begun by the person authorizing payment to another.

credit transfer–transaction in which a person making payment, such as a buyer, requests payment be made to the beneficiary's bank.

debit transfer–transaction in which a beneficiary entitled to money requests payment from a bank according to a prior agreement.

30-4e Definitions

Article 4A employs terms that are peculiar to that article or are used in a very different context from the contexts in which they appear elsewhere.

[48] The text refers to *debtor* and *creditor* in the interest of simplicity and because that situation is the most common in the business world. However, a gift may be made by a funds transfer. Likewise, a person having separate accounts in two different banks may transfer funds from one bank to another.

[49] U.C.C. §4A-108. This exclusion applies when any part of the transaction is subject to Regulation E adopted under the authority of that statute.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Funds Transfer

A **funds transfer** is more accurately described as a communication of instructions or a request to pay a specific sum of money to, or to the credit of, a specified account or person. There is no actual physical transfer or passing of money.

funds transfer–communication of instructions or requests to pay a specific sum of money to the credit of a specified account or person without an actual physical passing of money.

Originator

The person starting the funds transfer is called the **originator** of the funds transfer.[50]

originator–party who originates the funds transfer.

Beneficiary

The **beneficiary** is the ultimate recipient of the benefit of the funds transfer. Whether the recipient is the beneficiary personally, an account owned by the beneficiary, or a third person to whom the beneficiary owes money is determined by the payment order.

beneficiary–person to whom the proceeds of a life insurance policy are payable, a person for whose benefit property is held in trust, or a person given property by a will; the ultimate recipient of the benefit of a funds transfer.

Beneficiary's Bank

The **beneficiary's bank** is the final bank in the chain of transfer that carries out the transfer by making payment or application as directed by the payment order.

beneficiary's bank–the final bank, which carries out the payment order, in the chain of a transfer of funds.

Payment Order

The **payment order** is the direction the originator gives to the originator's bank or by any bank to a subsequent bank to make the specified funds transfer. Although called a *payment order*, it is in fact a request. No bank is required or obligated to accept a payment order unless it is so bound by a contract or a clearinghouse rule that operates independently of Article 4A.

payment order–direction given by an originator to his or her bank or by any bank to a subsequent bank to make a specified funds transfer.

30-4f Manner of Transmitting Payment Order

Article 4A makes no provisions for the manner of transmitting a payment order. As a practical matter, most funds transfers under Article 4A are controlled by computers, and payment orders are electronically transmitted. Article 4A, however, applies to any funds transfer payment order even if made orally, such as by telephone, or in writing. Also, the agreement of the parties or the clearinghouse and funds transfer system rules may impose some restrictions on the methods for communicating orders.

30-4g Regulation by Agreement and Funds Transfer System Rules

Article 4A, with minor limitations, permits the parties to make agreements that modify or change the provisions of Article 4A that would otherwise govern. Likewise, the rules of a clearinghouse or a funds transfer system through which the banks operate may change the provisions of the Code.

Choice of Law

When the parties enter into an agreement for a funds transfer, they may designate the law that is to apply in interpreting the agreement.

[50] U.C.C. §4A-201.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

Clearinghouse Rules

The banks involved in a particular funds transfer may be members of the same clearinghouse. In such a case, they will be bound by the lawful rules and regulations of the house.

The rights of the parties involved in a funds transfer may be determined by the rules of FedWire, a clearinghouse system operated by the Federal Reserve System, or by CHIPS, which is a similar system operated by the New York clearinghouse.

30-4h Reimbursement of the Bank

After the beneficiary's bank accepts the payment order, it and every bank ahead of it in the funds transfer chain is entitled to reimbursement of the amount paid to or for the beneficiary. This reimbursement is due from the preceding bank. By going back along the funds transfer chain, the originator's bank, and ultimately the originator, makes payment of this reimbursement amount.

30-4i Error in Funds Transfer

There may be an error in a payment order. The effect of an error depends on its nature.

Type of Error

The error in a payment order may consist of a wrong identification or a wrong amount.

Wrong Beneficiary or Account Number. The payment order received by the beneficiary's bank may contain an error in the designation of the beneficiary or in the account number. This error may result in payment being made to or for the wrong person or account.

Excessive Amount. The payment order may call for the payment of an amount that is larger than it should be. For example, the order may wrongly add an additional zero to the specified amount.

Duplicating Amount. The payment order may be issued after a similar payment order has already been transferred, so that the second order duplicates the first. This duplication would result in doubling the proper amount paid by the beneficiary's bank.

Underpayment. The payment order may call for the payment of a smaller sum than was ordered. For example, the order may drop off one of the zeros from the amount ordered by the originator.

Effect of Error

When the error falls under one of the first three classes just discussed, the bank committing the error bears the loss because it caused the item to be wrongfully paid. In contrast, when the error is merely underpayment, the bank making the mistake can cure the fault by making a supplementary order for the amount of the underpayment. If verification by the agreed-upon security procedure would disclose an error in the payment order, a bank is liable for any loss caused by the error if it failed to verify the payment order by such a procedure. In contrast, if the security procedure followed did not reveal any error, there is no liability for accepting the payment order.

When an error of any kind is made, there may be liability under a collateral agreement of the parties, a clearinghouse or funds transfer system rule, or general principles of contract law. However, these rights may be lost in certain cases by failure to notify the involved bank that the mistake has been made.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

30-4j Liability for Loss

Unless otherwise regulated by agreement or clearinghouse rule, banks have little or no liability in the funds transfer chain if they have followed the agreed-upon security procedure.

Unauthorized Order

If a bank executes or accepts an unauthorized payment order, it is liable to any prior party in the transfer chain for the loss caused. If a bank acts on the basis of an unauthorized order that nevertheless is verified by the security procedure, the bank is not liable for the loss that is caused.

Failure to Act

A bank that fails to carry out a payment order is usually liable, at the most, for interest loss and expenses. There is no liability for the loss sustained by the originator or for consequential damages suffered because payment was not made to satisfy the originator's obligation to the beneficiary.

Make the Connection

Summary

A *check* is a particular kind of draft; it is drawn on a bank and is payable on demand. A delivery of a check is not an assignment of money on deposit with the bank on which it is drawn. A check does not automatically transfer the rights of the depositor against the bank to the holder of the check, and there is no duty on the part of the drawee bank to the holder to pay the holder the amount of the check.

A check may be an *ordinary check*, a *cashier's check*, or a *teller's check*. The name on the paper is not controlling. Unless otherwise agreed, the delivery of a certified check, a cashier's check, or a teller's check discharges the debt for which it is given, up to the amount of the check.

Certification of a check by the bank is the acceptance of the check—the bank becomes the primary party. Certification may be at the request of the drawee or the holder. Certification by the holder releases all prior indorsers and the drawer from liability.

Notice of nonpayment of a check must be given to the drawer of a check. If no notice is given, the drawer is discharged from liability to the same extent as the drawer of an ordinary draft.

A depositor may stop payment on a check. However, the depositor is liable to a holder in due course unless the stop payment order was for a reason that may be raised against a holder in due course. The stop payment order may be made orally (binding for 14 calendar days) or with a record (effective for six months).

The depository bank is the agent of the depositor for the purpose of collecting a deposited item. The bank may become liable when it pays a check contrary to a stop payment order or when there has been a forgery or an alteration. The bank is not liable, however, if the drawer's negligence has substantially contributed to the forgery. A bank that pays on a forged instrument must recredit the drawer's account. A depositor is subject to certain time limitations to enforce liability of the bank. Banks are subject to reporting requirements under the USA Patriot Act.

A customer and a bank may agree that the bank should retain canceled checks and simply provide the customer with a list of paid items. The customer must examine canceled checks (or their electronic images) or paid items to see whether any were improperly paid.

An *electronic funds transfer (EFT)* is a transfer of funds (other than a transaction originated by check, draft, or other commercial paper) that is initiated through an electronic terminal, a telephone, a computer, or a magnetic tape to authorize a financial institution to debit or credit an account. The Electronic Funds Transfer Act requires

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

that a financial institution furnish consumers with specific information containing all the terms and conditions of all EFT services. Under certain conditions, the financial institution will bear the loss for unauthorized transfers. Under other circumstances, the consumer will bear the loss.

Funds transfers regulated by UCC Article 4A are those made between highly sophisticated parties that deal with large sums of money. If any part of the funds transfer is subject to the EFTA, such as consumer transactions, the entire transfer is expressly excluded from the scope of Article 4A. A funds transfer is simply a request or an instruction to pay a specific sum of money to, or to the credit of, a specified person.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

30-1 Checks

LO.1 List and explain the duties of the drawee bank

See the discussion of duties and Ethics & the Law on overdrafts, pages 579, 582–583.

LO.2 Explain the methods for, and legal effect of stopping payment

See Thinking Things Through, "The Business Law Professor with the Lost Cashier's Check," page 589.

See the Ethics & the Law on overdraft fees, page 580.

30-2 Liability of a Bank

LO.3 Describe the liability of a bank for improper payment and collection

See the *State Bank v. Smith* case for a discussion of liability related to cashier's checks, pages 576–577.

See the E-Commerce & Cyberlaw feature on the Nigerian e-mails, page 577.

See the Ethics & the Law feature for a discussion of overdraft fees issues, page 580.

See the *Aliaga Medical Center S.C. v. Harris Bank N.A.* case for a discussion on 90-day limits on cashing checks, pages 584–585.

LO.4 Discuss the legal effect of forgeries and material alterations

See the *Greenberg, Trager & Herbst v. HSBC Bank USA* case, page 583.

LO.5 Specify the time limitations for reporting forgeries and alterations

See the *Burns v. Neiman Marcus* case, page 587.

30-3 Consumer Funds Transfers

See the EFTA discussion, page 589.

30-4 Funds Transfers

LO.6 Describe the electronic transfer of funds and laws governing it

See the discussion of Article 4A, page 591.

Key Terms

agency
agent
bad check laws
beneficiary
beneficiary's bank
cashier's check
certified check
check
credit transfer
debit transfer
demand draft
electronic funds transfer (EFT)
Electronic Funds Transfer Act (EFTA)
encoding warranty
funds transfer
intermediary bank
money order
originator
overdraft
payment order
postdated
presentment
stale check
stop payment orders
substitute check
teller's check
time draft
USA Patriot Act
wrongfully dishonored

Questions and Case Problems

1. William Elias was the former owner of Direct Lending, a subprime mortgage company purchased by EA Management. Sometime after the sale, Elias went to Chase Bank and had three cashier's checks drawn to third parties and payable out of Direct Lending accounts in the amount of $191,251.31.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

When the new owners of Direct Lending checked their account balances online, they discovered the withdrawal for the three cashier's checks. The treasurer went to the bank and stopped payment on all three cashier's checks. Elias brought suit against the bank for wrongful dishonor and consequential damages to his businesses as a result of the dishonor. Can Elias recover? Be sure to explain which Article 4 provisions apply and why. [*EA Management v. JP Morgan Chase, N.A.*, 655 F.3d 573 (6th Cir.)]

2. Helen was a very forgetful person, so she had placed her bank code (PIN number) on the back of her debit card. A thief stole Helen's card and was able to take $100 from an ATM on the day of the theft. That same day, Helen realized that the card was gone and phoned her bank. The following morning, the thief withdrew another $100. For how much, if anything, is Helen responsible? Why?
3. Adam Paul Strege (APS) opened a checking account at U.S. Bank. Just below his signature card for the account, he wrote, "Call if I bounce a check." APS bounced several checks, and each time U.S. Bank covered those checks but it did not notify APS of the bounced check status. The result was that APS continued to write checks and U.S. Bank had to request funds from him to cover the overdrafts in his account. APS refused to pay the amount due because he argued that U.S. Bank had breached its agreement with him to report all bounced checks. Discuss whether U.S. Bank had the obligation to notify APS of the bounced checks. [*APS v. U.S. Bank*, 2009 WL 4723311 (D. Minn.)]
4. Arthur Odgers died, and his widow, Elizabeth Odgers (Elizabeth Salsman by remarriage), retained Breslow as the attorney for her husband's estate. She received a check payable to her drawn on First National City Bank. Breslow told her to deposit it in her husband's estate. She signed an indorsement "Pay to the order of Estate of Arthur J. Odgers." Breslow deposited this check in his trustee account in National Community Bank, which collected the amount of the check from the drawee, First City National Bank. Thereafter, Elizabeth, as administratrix of the estate of Arthur J. Odgers, sued National Community Bank for collecting this check and crediting Breslow's trustee account with the proceeds. Was National Community Bank liable? Explain. [*Salsman v. National Community Bank*, 246 A.2d 162 (N.J. Super.)]
5. Shipper was ill for 14 months. His wife did not take care of his affairs carefully, nor did she examine his bank statements as they arrived each month. One of Shipper's acquaintances had forged his name to a check in favor of himself for $10,000. The drawee bank paid the check and charged Shipper's account. Shipper's wife did not notify the bank for 13 months after she received the statement and the forged check. Can she compel the bank to reverse the charge? Why or why not?
6. Ann Weldon maintained an account at Trust Company Bank. James Weldon, her son and a garment broker, purchased textile goods from Sportswear Services for resale to another corporation known as Thicket Textiles. Sportswear demanded certified funds from James Weldon before it would ship the goods. When James Weldon requested a certified check from Trust Company, Trust Company officer Sweat informed James that if it issued a certified check, payment could not be stopped even if the merchandise delivered was not as promised under the terms of the contract.

   Ann Weldon then obtained a $16,319.29 cashier's check drawn on her account and payable to Sportswear. James had deposited his funds into her account to cover the check. The check was delivered to Sportswear, and the goods were shipped the next day, but they were defective.

   Ann Weldon went to Trust Company Bank to issue a stop payment order, and the bank, believing that the check had not yet been delivered to Sportswear, did so for $25. James Weldon then notified Sportswear of the stop payment order. After Trust Company dishonored the cashier's check, Sportswear's bank was in contact with the bank and informed it that the check had already been delivered to Sportswear. Trust Company honored the check and credited Ann Weldon's account with the $25 stop payment fee. Ann filed suit because Trust Company did not stop payment. Should payment have been stopped? Why or why not? [*Weldon v. Trust Co. Bank of Columbus*, 499 S.E.2d 393 (Ga. App.)]
7. Gloria maintains a checking account at First Bank. On the third day of January, the bank sent her a statement of her account for December accompanied by the checks that the bank had paid. One of the checks had her forged signature, which Gloria discovered on the 25th of the month when she prepared a bank reconciliation. On discovering this, Gloria

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

immediately notified the bank. On January 21, the bank had paid another check forged by the same party who had forged the December item. Who must bear the loss on the forged January check?

8. Dean bought a car from Cannon. As payment, Dean gave him a check drawn on South Dorchester Bank of Eastern Shore Trust Co. Cannon cashed the check at the Cambridge Bank of Eastern Shore Trust Co. The drawee bank refused payment when the check was presented on the ground that Dean had stopped payment because of certain misrepresentations made by Cannon. Will Eastern Shore Trust Co. succeed in an action against Dean for payment? [*Dean v. Eastern Shore Trust Co.*, 150 A. 797 (Md.)]

9. John G. Vowell and his wife, now deceased, had a checking account and a savings/money-market account with Mercantile Bank of Arkansas. In June 1997, Dr. Vowell and his wife allowed their daughter, Suzan Vowell, now also deceased, and her boyfriend to move in with them at their home. At that time, they knew that Suzan and her boyfriend had been involved with drugs, alcohol, writing bad checks, and stealing. They also knew that Suzan had stolen checks from them in the past and forged either Dr. Vowell's or his wife's signatures. They took precautions by hiding Mrs. Vowell's purse, which contained their checkbook, under the kitchen sink.

   Beginning in June 1997, Suzan forged Mrs. Vowell's signature on 42 checks, drawn on both accounts, and committed nine unauthorized ATM withdrawals in the aggregate amount of $12,028.75. Suzan found her mother's purse hidden under the kitchen sink and stole the checkbooks and ATM card from the purse. She apparently had access to the personal identification number (PIN) for the accounts because the number was identical to the home security system code.

   The Vowells received the following statements from the bank for the checking and savings accounts:

Date of Transaction	*Amount*	*Statement date covering*
July 9, 1997	$230.00	June 6–July 7, 1997
August 8, 1997	$1,235.25	July 8–August 6, 1997
August 23, 1997	$5,140.00	July 23–Aug 21, 1997
September 9, 1997	$1,423.50	Aug 7–Sept 7, 1997
September 26, 1997	$4,000.00	Aug 22–Sept 22, 1997

   On September 15, 1997, Dr. Vowell had Mercantile freeze their accounts and begin investigating the alleged forgeries and other unauthorized transactions pursuant to its policy. Suzan was arrested subsequently when she tried to use the ATM card again.

   The bank refused to credit the Vowells' account because it maintained that their negligence in handling their daughter caused the losses. The court found that the bank was liable for only $6,014.38, one-half of the entire sum of Suzan Vowell's unauthorized bank transactions and forgeries. The bank appealed. Can the Vowells recover? How much and why? [*Mercantile Bank of Arkansas v. Vowell*, 117 S.W.3d 603 (Ark. App.)]

10. Bogash drew a check on National Safety Bank and Trust Co. payable to the order of Fiss Corp. At the request of Fiss Corp., the bank certified the check. The bank later refused to make payment on the check because of a dispute between Bogash and the corporation over the amount due the corporation. Fiss sued the bank on the check. Can Fiss recover? [*Fiss Corp. v. National Safety Bank and Trust Co.*, 77 So. 2d 293 (N.Y. City Ct.)]

11. Rovell wrote a check to Pretty Eyes Detective Agency for $10,000 too much ($38,250). A staff member for Rovell gave a stop payment order and then issued a new check ($27,284.50). But the staff member was unsure of the check number. Pretty Eyes cashed both checks, Rovell's account was overdrawn, and he sued the bank. Is the check valid? Who gets the funds? Is it possible for Rovell to recover from the bank? [*Rovell v. American National Bank*, 232 B.R. 381, 38 U.C.C. 2d 896 (N.D. Ill. 1998)]

12. Norris, who was ill in the hospital, was visited by his sister during his last days. Norris was very fond of his sister and wrote a check to her that she deposited in her bank account. Before the check cleared, Norris died. Could the sister collect on the check even though the bank knew of the depositor's death? Explain. [In re *Estate of Norris*, 532 P.2d 981 (Colo.)]

13. Scott D. Leibling gave his bank, Mellon Bank, an oral stop payment order. Nineteen months later, the check emerged and Mellon Bank honored it. Leibling has filed suit against Mellon Bank for acting

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203

unreasonably under the circumstances. Is Mellon Bank liable to Leibling for paying the 19-month-old check when there was an oral stop payment order? Discuss your reasons for your answer. [*Leibling, P.C. v. Mellon, PSFS (NJ) N.A.*, 710 A.2d 1067, 35 U.C.C. 2d 590 (N.J. Super.)]

14. Hixson paid Galyen Petroleum Co. money he owed by issuing three checks to Galyen. The bank refused to cash the three checks because of insufficient funds in the Hixson account to pay all three. Galyen sued the bank. What was the result? Why? [*Galyen Petroleum Co. v. Hixson*, 331 N.W.2d 1 (Neb)]

CPA Questions

1. A check has the following endorsements on the back:
   (1) Paul Frank **"without recourse"**
   (2) George Hopkins **"payment guaranteed"**
   (3) Ann Quarry **"collection guaranteed"**
   (4) Rachell Ott

   Which of the following conditions occurring subsequent to the endorsements would discharge all of the endorsers?
   a. Lack of notice of dishonor.
   b. Late presentment.
   c. Insolvency of the maker.
   d. Certification of the check.

2. Blare bought a house and provided the required funds in the form of a certified check from a bank. Which of the following statements correctly describes the legal liability of Blare and the bank?
   a. The bank has accepted; therefore, Blare is without liability.
   b. The bank has not accepted; therefore, Blare has primary liability.
   c. The bank has accepted, but Blare has secondary liability.
   d. The bank has not accepted, but Blare has secondary liability.

3. In general, which of the following statements is correct concerning the priority among checks drawn on a particular account and presented to the drawee bank on a particular day?
   a. The checks may be charged to the account in any order convenient to the bank.
   b. The checks may be charged to the account in any order provided no charge creates an overdraft.
   c. The checks must be charged to the account in the order in which the checks were dated.
   d. The checks must be charged to the account in the order of lowest amount to highest amount to minimize the number of dishonored checks.

Copyright 2017 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203