16 Negotiable Instruments

Overview

As commerce and trade developed, people moved beyond the reliance on barter to the use of money. Gradually, there was a need to use substitutes for money, such as commercial paper. **Commercial paper** *is a contract for the payment of money.* It can serve as a substitute for money payable immediately, such as a check, or it can be used as a means of extending credit. Commercial paper, consisting of notes and drafts, reflects the needs of merchants, traders and importers. These groups were responsible for the development of the negotiable instrument and the eventual creation of a set of rules for settling disputes in the courts they established for that purpose. These instrument's rules became known as the law of negotiable instruments.

Gradually, the rules were codified and a uniform negotiable instruments act was passed by every state legislature. When the Uniform Commercial Code was drafted, Article 3 contained the statutory law that governs commercial paper. This Article (as enacted in different states) was in part superseded in 1987 when the U.S. Congress passed the Expedited Funds Availability Act, implemented by Availability Act Regulation CC of the Federal Reserve Board, which effectively superseded prior state laws. Article 3 of the UCC was then rewritten to comply with applicable federal laws and regulations and is now the principal source of law governing negotiable instruments.

THINK ABOUT THIS

Q. In your company's line of business, what are the most frequently used negotiable instruments and why?

Q. How can endorsements or notes change the negotiability of an instrument?

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- The concept of negotiability.
- Various kinds of negotiable instruments.
- The difference between special types of checks.
- Certificates of deposit.
- What negotiation of commercial paper means.
- Various types of endorsements.
- What checks marked "Paid in Full" mean.

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The Concept of Negotiability

The concept of negotiability is one of the most important features of commercial paper. A negotiable instrument is basically a piece of paper that can be transferred multiple times from one person/entity to another without the use of actual cash. It signifies or replaces money. A common example of a negotiable instrument is a check that can be endorsed multiple times by different parties. Each time it is endorsed and given to another, it represents payment to that party. Because of this feature, negotiable instruments are highly trusted and are used daily by millions of people. A **negotiable instrument** *is a written document, signed by the maker or drawer, containing an unconditional promise to pay, or order to pay, a certain sum of money on delivery or at a definite time to the bearer, or to the order of. It can be transferred from party to party and accepted as a substitute for money.* It is important to know whether an instrument is negotiable; if it is, any dispute concerning the instrument is resolved under Article 3 of UCC. (Figure 16-1)

Figure 16-1 **Negotiable Instrument**

$ 1,500.00 Anytown, USA, March 10, 20--

Sixty Days after date I promise to pay to

the order of Robert Jones

One thousand five hundred and 00/100 Dollars

Payable at Third National Trust

Value received with interest at 7%

No. 746 Due June 18, 20 -- *John Doe*

UCC 3-104(a) specifies that in order for an instrument to be negotiable, it must:

1. Be in writing.
2. Be signed by the maker or the drawer.
3. Be an unconditional promise or order to pay.
4. State a specific sum of money.
5. Be payable on demand or at a definite time.
6. Be payable to order or to bearer.

Comprehension Check
Define the term **negotiable instrument.**

Written Document

Negotiable instruments must possess the quality of certainty that only formal written expression can give, but the requirement is somewhat flexible in how it can be satisfied. The writing may be done in pen, printing, typewriting or pencil as long as it is legible. .

The surface on which the writing is executed must be capable of being circulated. The fact that an instrument is in writing means that the parol evidence rule governs the admissibility of oral evidence to contradict the terms of the instrument. **Parol evidence** *is a substantive rule of contracts under which a court will not receive into evidence prior oral statements that contradict a written agreement if the court finds that the written agreement was intended by the parties to be a final, complete and unambiguous expression of their agreement.*

Therefore, evidence of fraud, incompleteness, inconsistency, etc., is required before testimony on the terms of the instrument is allowed in court. There are also rules for interpreting problems that tend to occur frequently in the making out of such an instrument. Where there is a conflict of terms, the written terms take precedence over the typewritten terms or over any printed form term. In other words, if there is a conflict between the written amount and the amount expressed in numbers, the written amount wins out, due to the deliberation required to state it.

Signed by the Maker or Drawer

This second requirement is relatively straightforward: *The actual or authorized signature of the issuer is required for the instrument to be negotiable.* The **maker** *is the person or company who makes or executes a note.* A **note** *is an instrument containing an express and absolute promise of signer or maker to pay to a specified person, order or bearer a definite sum of money at a specified time.* The **drawer** *is the person or company who makes or executes a draft.* A **draft** *is a written order by the first party*, called the drawer, *instructing a second party*, called the **drawee** (*such as a bank*), *to pay money to a third party*, called a **payee.** Oral evidence is admissible to identify the signer of an instrument. For example, there are typically several people bearing a common name—such as John Smith. The appropriate person is allowed to testify as to which John Smith was the actual maker of the note.

If another person signs for the issuer (corporations may employ this method to utilize commercial paper), the person signing must be authorized to do so or be bound personally to pay the instrument. A failure to indicate that a person is signing in such a capacity, even if so authorized, obligates the signer personally. However, if the instrument is accepted and the signature is recognized as that of an authorized signer for the corporation, case law has shown that the person may not be individually liable.

Any form of signature is permissible as long as it indicates an intent to issue the instrument. Therefore, an instrument signed with an "X" is sufficient; witnesses to such a signing are a good idea but are not required technically. Also, the signature may appear anywhere on the face of the instrument although the usual place is the lower right-hand corner.

Unconditional Promise to Pay

The **unconditional promise to pay** requirement *maintains that the promise or order to pay contained in the commercial paper must not be conditional on the occurrence or nonoccurrence of some other event or agreement.* Requiring that something be done, or that a specific event occur before an instrument can be collected on, reduces the instrument to the status of a simple contract whose rights, at best, can merely be assigned.

A Sum Certain in Money

One requirement of a **sum certain** *is that the amount must be clearly ascertainable from the face of the instrument.* To qualify the instrument as negotiable, the sum certain must be calculable at two distinct times: at purchase and at maturity. When the holder considers buying the instrument, the exact minimum amount payable on it must be calculable from the information on its face. At maturity, the holder must be able to calculate from the face the exact amount due. For instance, a demand note payable with 10% interest meets the requirement of a sum certain because its amount can be determined at the time it is payable.

A second requirement is that *the instrument be payable in money.* **Money** *is defined as the medium of exchange that any domestic or foreign government has officially adopted as part of the currency.* If the instrument's value were stated in terms of services or merchandise, it would be too difficult to determine the market value at the time the instrument was to be paid. A promissory note that provides for payment in tin or hours of service is not payable in money. An instrument payable in shares of stock or government bonds is not negotiable, because neither stocks nor bonds are a medium of exchange recognized by the U.S. government.

On Demand or at a Definite Time

To satisfy this requirement, the time the instrument is payable must be determined in one of two ways. **On demand** *is synonymous with "at presentment" or "at sight" meaning that the holder has the option of choosing the time to receive payment.* Equally acceptable is specifying the time when the instrument matures. Such expressions as "due and payable 60 days from March 3, 20__," "due and payable 60 days from sight," or "due and payable on or before March 3, 20__" are all acceptable. The holder must be able to determine from the face of the instrument the latest possible time it can be paid without default.

Even if the instrument is subject to an acceleration clause, as long as a specific date is otherwise named, the instrument is still negotiable. An acceleration clause allows the obligee to declare the full amount due and payable upon the occurrence of a particular event, such as the failure to make a payment. An acceleration clause hastens the maturity date. An example is, "In case of default in payments of interest, or of an installment of the principal, the entire note shall become due and payable." Example: John lends Robert $1,500. Robert makes a negotiable note promising to pay $150 per month for 10 months. If the note contains a provision that if Robert fails to make a payment, the balance of the note is due at that time. If Robert fails to make the fourth payment, the balance of $1,050 is due to John immediately.

Payable to Order or Bearer

The last requirement is the most straightforward: An order or bearer instrument must be "payable to the order of the named payee(s)," "payable to the named payee's order" or some equivalent wording. A bearer instrument must be written "pay to bearer," "pay to cash," "pay to the order of the bearer," "pay to the order of the named payee(s) or bearer" or the like. Finally, if an instrument is made out to an obviously fictitious person, such as Superman, it is treated as a bearer instrument.

CONCEPT SUMMARY:
Eight Requirements for Negotiable Instruments

1. Must be in writing.	• A writing can be on anything that is readily transferable.
2. Must be signed by the instrument.	• The signature can be any place on the instrument. • It can be in any form (such as word, mark or stamp) that purports to be a signature and authenticates the writing. • It can be signed in a representative capacity.
3. Must be a definite order or promise to pay.	• A promise must be more than a mere acknowledgement of a debt. • The words "I/We Promise" or "Pay" meet this criterion.
4. Must be unconditional.	• Payment cannot be expressly conditional upon the occurrence of an event. • Payment cannot be made subject to or governed by another agreement. • Payment cannot be paid out of a particular fund (except for a government issued instrument).
5. Must be an order or promise to pay a sum certain.	• An instrument may state a sum certain even if payable in installments, with interest, at a stated discount or at an exchange rate. • Inclusion of cost of collection and attorney's fees does not disqualify the statement of a sum certain.
6. Must be payable in money.	• Any medium of exchange recognized as the currency of a government is money. • The maker or drawer cannot retain the option to pay the instrument in money or something else.

7. Must be payable on demand or at a definite time.	• Any instrument payable on sight, presentation or issue is a demand instrument. • An instrument is payable at a definite time even though it is payable on a stated date, or within a fixed period after sight, or the drawer or maker has an option to extend time for a definite period. • Acceleration clauses, even if unenforceable, do not affect the negotiability of the instrument.
8. Must be payable to order or bearer.	• An order instrument must name the payee with reasonable certainty. • An instrument whose terms intend payment to no particular person is payable to bearer.

Comprehension Check
Give a brief explanation of the elements of a **negotiable instrument.**

Kinds of Negotiable Instruments

To some extent, commercial law is a reflection of customs and usages of trade in the business world. The development of the law concerning commercial paper—checks, promissory notes and the like—grew from commercial necessity. In 1896, the National Conference of Commissioners on Uniform Laws drafted the Uniform Negotiable Instruments Law. This law was reviewed by the states, and by 1920 all had adopted it. The Uniform Negotiable Instruments Law was the forerunner of Article 3 of the Uniform Commercial Code (UCC).

There are four types of instruments specified in UCC 3-104, which serve as a substitute for money and as a credit device:

1. Drafts.
2. Checks.
3. Notes.
4. Certificates of deposit.

Comprehension Check
List the basic types of negotiable instruments.

Drafts

A **draft**, also known as **a bill of exchange**, *is an instrument that orders someone else to pay.* The order is given by the drawer, who issues the draft usually by signing it in the lower right-hand corner. The one who is ordered to pay the money is called the drawee. The one who is to receive the money is known as the payee.

Drafts may be presented to the drawee for payment or for acceptance. When a draft is presented for acceptance, the drawee is asked to become liable on the instrument. To accept a draft, the drawee writes “accepted” across the face of the instrument, and dates and signs it. By doing this, the drawee agrees to pay the instrument at a later date when it becomes due. (*See* Figure 16-2.)

Figure 16-2 **Sight Draft**

$ 576.00 Anytown, USA, May 3, 20--

At sight Pay to

the order of

Five hundred seventy-six and 00/100 Dollars

Bill of lading attached

Value received and charge the same to account of

To World Shipping } Davis Company

No. 361 Anytown, USA } *John Doe*

Checks

A **check** *is a draft on which the drawee is a bank that is ordered to pay on demand;* it is the most common form of a draft. It is drawn on a bank by a drawer, who has an account with the bank, to the order of a specified person or business named on the check, or to the bearer. Ownership of a check may be transferred to another person by the endorsement of the payee. In this manner, a check may circulate among several parties, taking the place of money. Banks provide regular and special printed check forms. These check forms display a series of numbers printed in magnetic ink, known as the MICR line, which makes it possible to process checks electronically and accurately. Among the information found on a MICR line is the check number (usually located to the far left). If the magnetic numbers do not match the printed numbers at the upper right, the check is likely fraudulent and should not be accepted.

The use of printed forms is not required. Any writing, no matter how crude, may be used as a check if it is a draft drawn on a bank and payable on demand.

Comprehension Check
What is a **check**?

Special Types of Checks

Bank Drafts

A **bank draft,** sometimes called a **teller's check or a treasurer's check**, *is a check drawn by one bank on another bank in which it has funds on deposit in favor of a third person, the payee.*

Cashier's Checks

A **cashier's check** *is a check drawn by a bank upon itself.* The financial institution is both the drawer and the drawee. The bank, in effect, lends its credit to the purchaser of the check. Courts have held that payment cannot be stopped on a cashier's check because the bank, by issuing it, accepts the check in advance.

Certified Checks

A **certified check** *is a check that is guaranteed by the bank.* At the request of either the depositor or the holder, the bank acknowledges that sufficient funds will be withheld from the drawer's account to pay the amount stated on the check. The UCC provides that "certification of a check is acceptance." This means that a drawee bank that certifies a check becomes primarily liable on the instrument just the same as the acceptor of a draft. The bank has absolute liability to pay.

Whether anyone is secondarily liable depends upon who had the check certified. If the drawer had the check certified, the drawer and all endorsers remain secondarily liable on the instrument. If, on the other hand, the holder had the check certified, the drawer and all prior endorsers are discharged. The UCC places no obligation on a bank to certify a check if it does not want to do so.

Money Orders

A **money order** is usually presumed to have the significance of cash, but one must be aware of the issuer's identity and validity. In some areas of the country, money orders are sold by companies other than financial institutions or the U.S. Postal Service. They are privately-owned companies and may or may not have sufficient cash to cover the money order when it is presented for payment. Caution is advised when accepting a money order as payment if the issuer is not known. Investigate the issuer before negotiating the instrument.

Traveler's Checks

A **traveler's check** *is similar to a cashier's check in that the issuing financial institution is both the drawer and the drawee.* The purchaser signs the checks in the presence of the issuer when they are purchased. Technically, most traveler's checks are not checks but drafts, because the drawee—for example, American Express—is not ordinarily a bank.

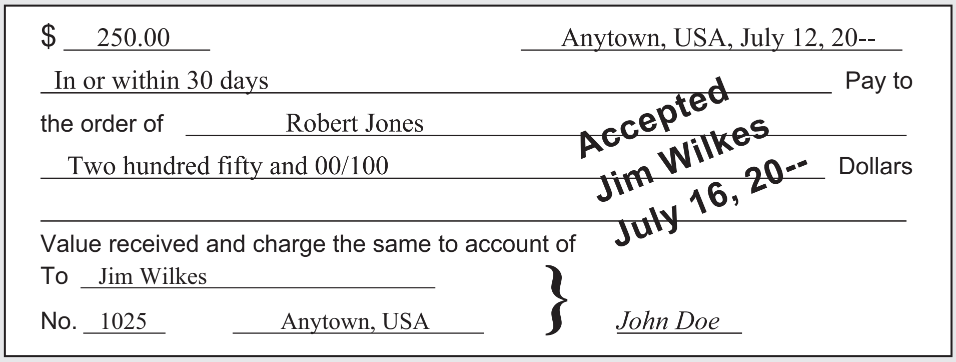
Postdated Checks

A check may be **postdated** *when the drawer has insufficient funds in the bank but expects to have sufficient funds to cover the amount of the check at a future date.* A postdated check is not usually covered in the bad check laws of the states. Third-party collectors subject to the Fair Debt Collection Practices Act are restricted in their reliance on postdated checks.

Sight Drafts, Time Drafts and Trade Acceptances

A **sight draft** *is payable as soon as it is presented to the drawee for payment. A* **time draft** *is not payable until the lapse of a particular time period stated on the draft.* A **trade acceptance** *is a draft used by a seller of goods to receive payment and also to extend credit.* It is often used in combination with a bill of lading, which is a receipt given by a freight company to someone who ships goods. For example, a seller ships goods to a buyer and sends a bill of lading, with a trade acceptance attached, to a bank in the buyer's city. The trade acceptance is drawn by the seller ordering the buyer to pay either the seller or someone else. If it is a sight draft, the buyer must pay the draft immediately to receive the bill of lading from the bank. If it is a time draft, the buyer must accept the draft to receive the bill of lading from the bank. The freight company will not release the goods to the buyer unless the buyer has the bill of lading. (*See* Figures 16-2 and 16-3.)

Figure 16-3 **Time Draft**


$ 250.00 Anytown, USA, July 12, 20--
In or within 30 days Pay to
the order of Robert Jones
Two hundred fifty and 00/100 Dollars
Value received and charge the same to account of
To Jim Wilkes
No. 1025 Anytown, USA *John Doe*
Accepted
Jim Wilkes
July 16, 20--

Domestic Bill of Exchange

A **domestic bill of exchange** *is a draft that is drawn and payable in the United States. A draft that is drawn in one country but is payable in another is called an* **international bill of exchange** *or* **foreign draft.**

Notes

A **note,** or **promissory note,** *is a written promise by one party, called the maker, to pay money to the order of another party, called the payee.* In contrast with drafts, notes are promise instruments rather than order instruments, and they involve only two parties instead of three. They are used by people who loan money or extend credit as evidence of debt. *When two or more parties sign a note, they are called* **co-makers.**

Demand Notes

A **demand note**, *as its name implies, is payable whenever the payee demands payment.* A **time note** *is payable at some future time, on a definite date named in the instrument.* Unless a note is payable in installments, the principal (face value) of the note plus interest must be paid on the date that it is due. In an **installment note,** *the principal, together with interest on the unpaid balance, is payable in installments at specified times.* (*See* Figure 16-4.)

Figure 16-4 **Demand Note**

Anytown, USA, February 27, 20--

On demand, the undersigned, for value received, promise(s) to pay to the order of

anytown trust company

Five thousand two hundred and 00/100 Dollars

at its offices in Anytown, USA, together with interest thereon from the date thereof until paid at the rate of 10 percent per annum.

500 Anyroad Street

Anytown, USA *John Doe*

Promissory Notes

Promissory notes come in the following forms:

- **Single-name paper** *is a note signed by only one maker.* No one else is liable on it.
- **Double-name paper** *is a promissory note signed by two or more makers or signed by the maker and endorsed by others.* With additional people standing behind the note, the likelihood of payment is increased.

A **straight note** *is the more common instrument, used merely as evidence of indebtedness.* To make certain that the note is negotiable, the word "order" must be used.

In a **serial note,** *the amount to be paid is covered by a series of notes usually of equal amounts and with maturity dates equally spaced.* A provision is usually added, stating that in the event of a default in payment, all subsequent notes become due and payable. Thus, notes with stated maturities are converted into demand instruments under this provision.

Promissory notes are commonly used for bank loans. They are not frequently used for merchandise transactions. However, some credit executives will ask their customers to sign a note for past-due accounts, believing that it will stimulate payment and make collection of the account easier. This practice provides written acknowledgment of the past-due debt, while also postponing the due date of the account until the date stated on the note.

Collateral Notes

A **collateral note** *is a note that is secured by certain collateral, such as stocks, bonds, personal property or mortgages.* Its outstanding feature is that the collateral is held by the creditor while the note is outstanding. Such a note may be negotiated in the same manner as any negotiable note, whether the collateral is assigned or not.

Judgment Notes

Judgment notes *are controlled by state law and have many technical requirements associated with them.* These promissory notes are generally given in connection with a separate agreement by the maker who consents to have a judgment entered should payment not be made on the note when due. *The separate agreement consenting to the judgment is known as a* **confession of judgment.** Clauses that sanction confession of judgment prior to maturity are not authorized by the UCC because they do not contain an unconditional promise to pay at a definite time.

The note may be endorsed and negotiated by the payee in the same manner as any other negotiable instrument. The confession of judgment is not negotiable but may be assigned by the payee to an endorsee along with the note. *In essence, the confession of judgment enables a creditor to enter a judgment without going to trial. Because it usually can be entered without advising the debtor, it has been criticized as violating the constitutional rights of due process.*

Comprehension Check
What are some of the types of payment?

Certificates of Deposit

A **certificate of deposit (CD)** *is an acknowledgment by a bank of the receipt of money and its promise to pay the money back on the due date, usually with interest.* Certificates of deposit generally pay more interest than regular savings accounts because the depositor cannot withdraw the money before the due date without penalty. Their negotiability allows them to be sold, to be used to pay debts or to serve as security or collateral for a loan or credit agreement.

Negotiation of Commercial Paper

Assignment

Commercial paper that does not meet all of the requirements of negotiability may only be transferred by assignment, which is governed by the ordinary principles of contract law. An **assignment** *is the transfer of contract rights from one person to another.* Commercial paper is assigned either when a person whose endorsement is required on an instrument transfers it without endorsing it or when it is transferred to another person and does not meet the requirements of negotiability. In all such transfers, the transferee has only the rights of an assignee and is subject to all defenses existing against the assignor.

An assignment of commercial paper also occurs by operation of law when the holder of an instrument dies or becomes bankrupt. In such cases, title to the instrument vests in the personal representative of the estate or the trustee in bankruptcy.

Negotiation

Negotiation *is the transfer of an instrument in such a form that the transferee becomes a holder.* A **holder** *is a person who is in possession of an instrument issued or endorsed to that person, to that person's order, to bearer or in blank.* For example, XYZ Supply issues a payroll check "to the order of Mary Jones." Jones takes the check to the supermarket, signs her name on the back (an endorsement), gives it to the cashier (at delivery) and receives cash. Smith has negotiated the check to the supermarket.

If an instrument is payable to order, such as "pay to the order of," it is known as **order paper.** To be negotiated, order paper must be endorsed by the payee and delivered to the party to whom it is transferred. *If an instrument is payable to bearer or cash, it is called* **bearer paper** *and may be negotiated by delivery alone, without an endorsement.* When order paper is endorsed with a blank endorsement, it is turned into bearer paper and may be further negotiated by delivery alone. The use of bearer paper involves more risk through loss or theft than the use of order paper.

Assume Susan Smith writes a check "payable to cash" and hands it to John Doe (at delivery). Smith has negotiated the check (a bearer instrument) to Doe. Doe places the check in his wallet, which is subsequently stolen. The thief has possession of the check. At this point, negotiation has not occurred, because delivery must be voluntary on the part of the transferor. If the thief "delivers" the check to an innocent third person, however, negotiation will be complete. All rights to the check will be passed absolutely to that third person, and Doe will lose all right to recover the proceeds of the check from the third person. Of course, Smith can recover her money from the thief if the thief can be found!

Comprehension Check
Define the concept of **negotiation.**

Endorsements

An instrument is **endorsed** *when the holder signs it, thereby indicating the intent to transfer ownership to another.* Endorsements may be written in ink, typewritten or stamped. They may be written on a separate piece of paper that becomes part of it. Although the UCC does not require endorsements to be on the back of the instrument, they are usually placed on the back of the instrument for convenience purposes. Each endorsement of a negotiable instrument is a separate contract, standing apart from that of the maker or any other endorser.

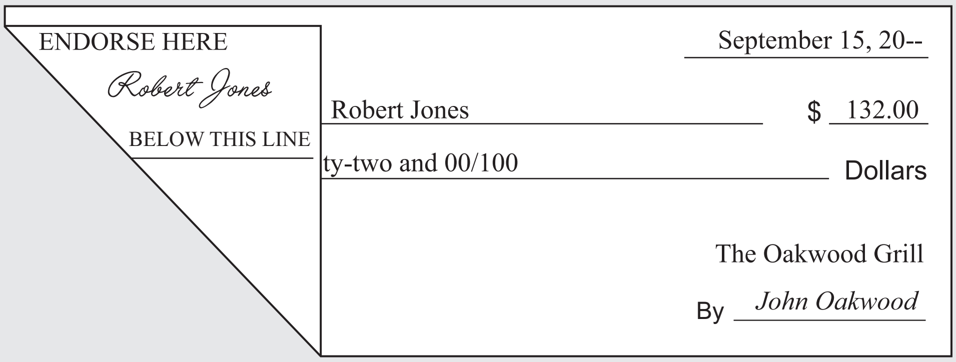
Once an instrument qualifies as a negotiable instrument, the form of endorsement will have no effect on the character of the underlying instrument. Endorsement relates to the right of the holder to negotiate the paper and the manner in which negotiation must be done.

Common Types of Endorsements

Blank Endorsement

A **blank or general endorsement** *consists merely of the signature of the payee and converts the instrument into a bearer instrument and may be transferred by delivery alone.* No particular **endorsee,** *person to whom an instrument is endorsed,* is named. If the instrument is lost or stolen and gets into the hands of another holder, the new holder can recover its face value by delivery alone. (*See* Figure 16-5.)

Figure 16-5 **Blank Endorsement**

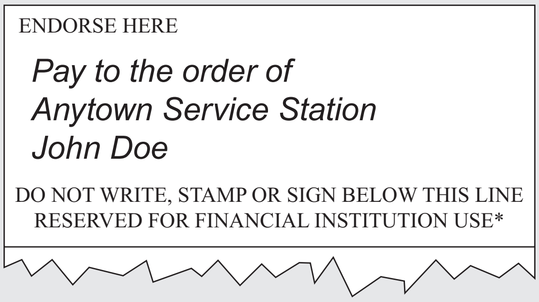


When an instrument is made payable to a person under a misspelled name or a name other than that person's own, the payee may endorse in the incorrect name, in the correct name or in both. Signatures in both names may be required by a person paying or giving value to the instrument.

Special Endorsement

A **special endorsement,** *also called an endorsement in full, is made by writing the words "pay to the order of" or "pay to" followed by the name of the person to whom it is to be transferred (the endorsee) and the signature of the endorser.* A special endorsement is one that specifies to whose order an instrument is payable. (*See* Figure 16-6.)

Figure 16-6 Special Endorsement



Restrictive Endorsement

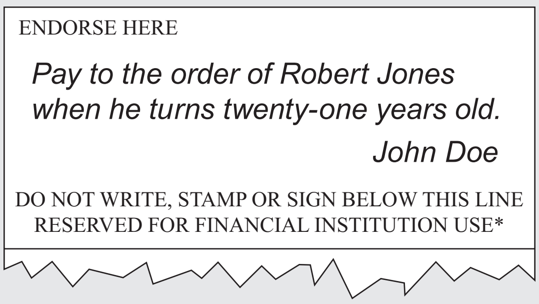
A **restrictive endorsement** *limits the rights of the endorsee in some manner in order to protect the rights of the endorser.* An endorsement is restrictive if it is conditional; attempts to prohibit further transfer of the instrument; includes the words "for collection," "for deposit," "pay any bank" or like terms signifying a purpose of deposit or collection; or otherwise states that it is for the benefit or use of the endorser or of another person. (*See* Figure 16-7.)

Figure 16-7 Restrictive Endorsement

Conditional Endorsement

A **conditional endorsement,** *a type of restrictive endorsement, makes the rights of the endorsee subject to the occurrence of a certain event or condition. (See* Figure 16-8.)

Figure 16-8 Conditional Endorsement



Endorsements for Deposit or Collection

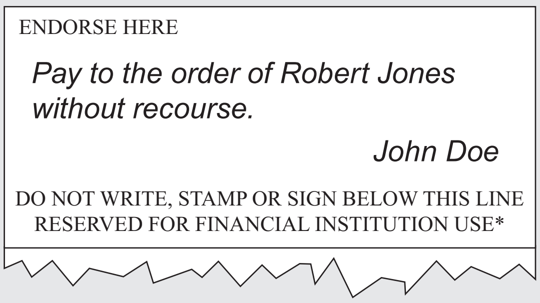
Endorsements for deposit or collection are designed to get an instrument into the banking system for the purpose of deposit or collection. *When a check is endorsed "for deposit only," the amount of the instrument is credited* *to the endorser's account before it is negotiated further.* Retail stores often stamp each check "for deposit only" when it is received. This wording provides protection in the event the check is stolen. Checks mailed to a bank for deposit should always be endorsed in this way.

Qualified Endorsement

A **qualified endorsement** *is one in which words have been added to the signature that limit the liability of the endorser.* By adding the words "without recourse" to the endorsement, the endorser disclaims liability on the instrument and cuts off their obligation to future endorsers and holders to pay on the instrument. The mere use of the words "without recourse" does not wholly relieve the endorser from liability. Under UCC 3-417, it is provided that every person who signs their name as a qualified endorser of a negotiable instrument warrants, by their signature, that:

1. they have good title to the instrument or are authorized to obtain payment or acceptance on behalf of one who has good title and the transfer is otherwise rightful;
2. all signatures are genuine or authorized;
3. the instrument has not been materially altered;
4. they have no knowledge of any defense of any party that is good against them;
5. they have has no knowledge of any insolvency proceeding instituted with respect to the maker, acceptor or drawer of an unaccepted instrument. (*See* Figure 16-9.)

Figure 16-9 Qualified Endorsement



General Endorsements

A **general endorsement** *is without reservation or qualification.* A general endorser warrants everything mentioned in 1, 2, 3 and 5 above and that they have good title. There is no defense of any party that is good against them and that they have no knowledge that the drawer's or maker's signature is unauthorized and that the endorsement has not been materially altered.

Comprehension Check
List and describe the types of **endorsements.**

Checks Marked "Paid in Full"

The general rule when receiving a check marked "Paid in Full" is as follows: If the claim is paid and there is no dispute as to the amount due, a check for a lesser amount than the claim, even though marked "Paid in Full" does not settle the account. The creditor may keep the check and sue for the balance. If, however, there is a *bona fide* dispute as to the amount of the claim, and the same claim is not liquidated, a check sent and marked "Paid in Full," or "In full payment of account" is payment in full. Consequently, the creditor must either return the check and sue for the amount claimed or accept the check in complete payment. Whether a *bona fide* dispute exists can be a matter of dispute in itself, and obviously a debtor wishing to pay a lesser sum can very easily make such a claim. A good practice before accepting a check marked "Paid in Full" is to be very certain there is no dispute. It is all too common for someone outside the credit department to be aware that the customer has disputed the amount due because of pricing, time of delivery, damage, merchandise not meeting specifications, etc.

The retention and deposit of the check by the creditor may constitute an accord and satisfaction even though the creditor notifies the debtor that it has only received a partial payment on account. The creditor is therefore placed in a difficult position: either they must reject such a check and demand payment of the full amount, or accept the check and possibly be deemed to have made an accord and satisfaction. One possible solution to this problem is to stamp all collection checks with a legend that states:

> "This check is accepted without prejudice and with full preservation of all rights pursuant to Section 1-204 of the UCC."

Under this UCC section, a party who explicitly so reserves their rights does not prejudice the rights reserved. Some courts have held that this section of the UCC applies only to UCC-covered transactions such as the sale of goods, and does not apply to service contracts; other courts have entirely rejected the application of the UCC to checks marked "Paid in Full." In some instances, however, the courts have held that where a creditor gave a release under seal, the acceptance of a smaller amount than the amount due, even in a liquidated claim, releases the debt.

Comprehension Check
What is the general rule for handling a check marked "Paid in Full"?

Check Writing Alternatives*

During the past several years, the financial services industry has made significant progress in migrating consumers from paper checks to electronic payments such as credit and debit cards at the point of sale, online bill payment through Internet banking and biller websites, and traditional ACH applications of direct payment and direct deposit. However, the same level of progress has not occurred in moving businesses from checks to electronic payments.

The research confirms that businesses continue to write checks because they perceive this to be the most convenient method of payment to trading partners and sellers. A primary reason cited for using checks is the availability of remittance information that flows with the payment.

While most companies use both checks and wire transfers, more than 80 percent of the volume of all corporate payments is sent using checks.

This broad finding is consistent with recent studies from The Clearing House Payments Company, Association of Financial Professionals and the Federal Reserve Banks. Corporations remain slow to adopt electronic payments for the following reasons:

- Checks are easier to initiate and have perceived float advantages.
- Cash management and accounting systems do not provide the features desired to send and receive payments electronically.
- For wire transfer payments, no standard exists for sending remittance information that allows efficient reconciliation and posting of electronic payments once they are received.

** Excerpted from* Business-to-Business Wire Transfer Payments: Customer Preferences and Opportunities for Financial Institutions *prepared by the The Clearing House and the Federal Reserve Financial Services.*

Real World Perspectives

RWP 16-1

EFT/ACH BECOMING THE NEW BAD CHECKS?

As the ratio of business-to-business transactions increasingly moves away from paper checks and surface mail toward technology-fueled options like electronic funds transfer (EFT) and automated clearing house (ACH), problems generated by bad actors are becoming more frequent. Creditors familiar with bad check writers in the past are now finding more rejections of EFT and ACH transactions because of insufficient funds, especially in high-turn/frequent-delivery industries related to food products and other perishables.

The vast majority of NACM members polled in an NACM survey (78%) indicated that customers have increased their EFT and ACH payments over the last few years. Those working for companies slow to adopt, noted expanded plans to accept electronic payment with greater efficiency, usually at the company's request.

"We do more and more with EFT and ACH every day; and for the most part, we have great success with it. But, as with checks, there are returned items, and there are more issues simply because this is where the industry is going," said Michael Castania, controller and former credit manager at McAneny Brothers, Inc.

Though far from widespread, bad EFT/ACH payment incidents have become more frequent. Statutory language from state to state typically addresses "bad check" situations, but it rarely specifies or defines EFT or ACH protocol and can be wildly inconsistent. In addition, enforcement at the local level can be even more unpredictable.

"With EFT, the laws are kind of nebulous," said Sam Rousseau, of Liberty USA, Inc. "With bad checks, in states including Pennsylvania, you'd traditionally go to your magistrate, which is the lowest level of the judiciary, and present your case to an assistant district attorney. They're not quite sure of the position they can take [on electronic payment] and the law on this. It leaves us hanging out there."

In addition, ill intent is difficult to prove, significantly more so than with bad checks. According to NACM business partner United Tranzactions (UTA), a check is a legal binding contract with a signature, and there is definite intent to pay somebody; with ACH, most often you don't have a signature. Because of this, all you can do in a lengthy dispute is go to court and make your case and explain your agreement with the debtor. But you won't have much case law behind you and intent is harder to prove. For that reason, UTA has always been careful to remind that you don't necessarily have that legal binding contract with ACH and EFT.

Rousseau noted that laws in many states don't even cover bad checks well, let alone iterations like EFT. "It would be nice on a state or federal level to get it defined because EFT is the future of payment," he noted.

In the absence of widespread statutory language changes or demands from state or federal officials for greater enforcement, consider the following:

- Look at your forms/documents. "With the right documents and forms, you can more easily get legal professionals involved," said PACM President Harold Booth, CGA.
- Document relationships with customers thoroughly and early. "The better-worded and more clear-cut your documentation is, the better your chances are," said Castania.
- Try to reach out/work with the customer first. "If they're willing to work with us, it doesn't need to go further," said Castania.
- Change access to certain payment methods. "Require checks or wire transfers or some other form of payment for a habitual offender," said Rudet Fountain, NACM-National.
- If not resolved quickly, try using bad check precedent with the customer and "send a Notice of Dishonor saying they need to make good," said Nick Krawec, Esq., partner at law firm Bernstein-Burkley, PC. Payment will often follow, despite legal statute vagaries.
- If all else fails, go to court. "The only way to find out if bad check law applies to EFT is to take it to court ... Maybe it takes a court decision or two to show what the appetite for this issue is," said Krawec.
- Contact state or federal elected representatives. Tell lawmakers, "I couldn't get a judgment because of the way the statute is written. What are you going to do about that?" Remind them that you vote, said Krawec.

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Key Terms and Concepts

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Comprehension Check

1. Define the term **negotiable instrument.**
2. Give a brief explanation of the elements of a **negotiable instrument.**
3. List the basic types of negotiable instruments.
4. What is a **check?**
5. Define the following terms:
   a. **bank draft**
   b. **cashier's check**
   c. **certified check**
   d. **money order**
   e. **traveler's check**
   f. **postdated check**
   g. **sight and time drafts**
   h. **domestic bill of exchange**
   i. **demand note**

    j. **promissory note**
    k. **collateral note**
    l. **judgment note**
6. Define the concept of **negotiation.**
7. List and describe the types of **endorsements.**
8. What is the general rule for handling a check marked "Paid in Full"?

Summary

- A negotiable instrument is basically a piece of paper that can be transferred multiple times from one person/entity to another without the use of actual cash.
- Each time it is endorsed and given to another, it represents payment to that party, which makes it a highly trusted instrument used by millions of people.
- The elements of a negotiable instrument include:
  - Be in writing
  - Be signed by the maker or drawer
  - Be an unconditional promise or order to pay
  - State a specific sum of money
  - Be payable on demand or at a definite time
  - Be payable to order or to bearer
- A drawer is the person or company who makes or executes a draft
- A draft is a written order by the first party, instructing the second party to pay money to a third party.
- **Negotiable instruments** include
  - **Drafts**
  - **Checks**
  - **Notes**
  - **Certificates of deposit**
- Checks are the most **common form of draft.** Special types of checks include:
  - **Bank drafts**
  - **Cashier's checks**
  - **Certified checks**
  - **Money orders**
  - **Traveler's checks**
  - **Postdated checks**
  - **Sight drafts, time drafts or trade acceptances**
  - **Domestic bill of exchange**
- **Notes** are a written promise by one party to pay money to the order of another party. Types include:
  - **Demand notes**
  - **Promissory notes**
  - **Collateral note**
  - **Judgment notes**

- A certificate of deposit is an acknowledgement by a bank of the receipt of money and its promise to pay money back at a future date, normally with interest. It normally pays more interest because the money cannot be withdrawn by the depositor before the due date without a penalty.
- Commercial paper does not meet all of the requirements of negotiability and may only be transferred by assignment.
- Negotiation is the transfer of an instrument in such a form that the transferee becomes a holder.
- An instrument becomes endorsed when it is signed by the holder, thereby transferring the ownership to another. **Common endorsements** include:
  - **Blank endorsement**
  - **Special endorsement**
  - **Restrictive endorsement**
  - **Conditional endorsement**
  - **Endorsement for deposit or collection**
  - **Qualified endorsement**
  - **General endorsement**
- The general rule for receiving a check labeled "Paid in Full" is as follows: an account is not considered settled even if labeled as "Paid in Full" and the check is for a lesser amount than the claim. The creditor may keep the check and sue for the balance. However, there are benefits and costs associated with the steps taken by the creditor depending on whether they decide to liquidate the payment or send the payment back to be paid in full.

References and Resources

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