Chapter 14

**Negotiable Instruments**

Answers to Learning Objectives/

Learning Objectives Check Questions

at the Beginning and the End of the Chapter

**Note that your students can find the answers to the even-numbered *Learning Objectives Check* questions in Appendix E at the end of the text. We repeat these answers here as a convenience to you.**

**1A.** ***What requirements must an instrument meet to be negotiable?*** 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 fixed amount of money, (5) be payable on demand or at a definite time, and (6) be payable to order or to bearer, unless it is a check.

**2A.** ***How does the negotiation of order instruments differ from the negotiation of bearer instruments?*** Negotiating order instruments requires both delivery and indorsement, whereas negotiating bearer instruments is done by delivery alone (without the need for indorsement).

**3A.** ***What are the requirements for attaining the status of a holder in due course (HDC)?*** A holder of a negotiable instrument becomes a holder in due course (HDC) if he or she takes the instrument (1) for value; (2) in good faith; and (3) without no­tice that the in­strument is overdue, that it has been dishonored, that any per­son has a defense against it or a claim to it, or that it contains unauthorized signatures or alterations, or is so ir­regular or incomplete as to call into ques­tion its authenticity.

**4A.** ***What is the difference between signature liability and warranty liability?*** The key to liability on a negotiable instrument is a signature. Every party, ex­cept a qualified indorser, who signs a negotiable instrument is primarily or secon­darily liable for payment of that instrument when it comes due. Signature liabil­ity arises from in­dorsing an instrument. Warranty liability arises from trans­ferring an instrument, whether or not the transferor also in­dorses it.

**5A.** ***Name four******defenses that can be used against an ordinary holder but are not effective against an HDC.*** Personal defenses are good only against the claims of ordinary holders. These defenses include breach of contract or warranty, lack or failure of considera­tion, fraud in the inducement (ordinary fraud), and illegality, mental incapacity, and ordinary duress.

Answer to Critical Thinking Question

**in the Feature**

**Beyond Our Borders—Critical Thinking**

***What would be the cost to individuals and businesses that use checks if a similar law were passed in this country?*** The flexibility of our banking system would be severely restricted. Checks would lose some of their value as negotiable instruments.

Answers to Critical Thinking Questions

in the Cases

**Case 14.1—What If the Facts Were Different?**

***If AOA’s suit had fallen within the four-year statute of limitations of the UCC’s Article 2, could the seller have filed its claim on either the contracts or the notes? Explain.*** Yes. If AOA had brought its suit to fall within the four-year statute of limitations under UCC Article 2, the seller would have filed its claim on either the contracts or the notes. In holding that the notes were negotiable, the court in the *Alpaca* case determined that the notes were separate and distinct from the underlying sales contracts, Thus, AOA could have sued on either the contracts under UCC Article 2 or on the notes under UCC Article 3. Of course, AOA filed its claim only on the notes, so the six-year statute of limitations applied.

**Case 14.2—What If the Facts Were Different?**

***Suppose that the note had described the amount of the loan as “ONE MILLION SEVEN HUNDRED THOUSAND AND NO/100 ($1,007,000.00) DOLLARS.” What would have been the result?*** In the circumstances set out in the question, the Charles R. Tips Family Trust would have been liable to PB Commercial, LLC (PBC) for $230,289—the difference between $1,700,000 and $1,469,711.

If the note had described the amount of the loan as “ONE MILLION SEVEN hundred THOUSAND AND NO/100 ($1,007,000.00) DOLLARS,” the words would have conflicted with the note’s numerals by the same amount as in the facts of the case—$693,000. But the parties’ positions with respect to this amount would have been reversed. According to UCC 3–114, “words prevail over numbers.” Under the principle cited, and the reasoning applied, by the court, the size of the discrepancy “does not matter” and the amount of the loan would be determined from the printed words. The trust made payments on the note totaling $595,586, and PBC foreclosed on the collateral and sold it for $874,125. The trust would be liable to PBC for the difference between these amounts and the amount of the note.

Case 14.3—Critical Thinking—Economic Consideration

***How does presuming that an indorsement is legitimate “without unambiguous evidence to the contrary” protect the transferability of a negotiable instrument?*** The presumption that an indorsement is legitimate “without unambiguous evidence to the contrary” protects the transferability of a negotiable instrument by giving force to the information presented on the face of the instrument. Thus, a signature is an indorsement unless accompanying words, the terms of the instrument, the location of the signature, or some other circumstance unambiguously indicates that the signature was made for a purpose other than indorsement.Parties can buy, sell, or trade the instrument, trusting that the indorsements on it are legitimate without having to validate every indorsement with every transfer. This encourages and supports the market for such instruments.

Answers to Questions in the Reviewing Feature

at the End of the Chapter

**1A.** ***Type of instrument***

Durbin’s note was a promissory note—a written promise made by one person (the maker of the promise to pay) to another (usually a payee). This instrument is, as defined, a promise to pay.

**2A.** ***Rate of interest***

The note would not fail to meet the requirements for negotiability on this basis. Negotiable instruments must state with certainty a fixed amount of money to be paid at any time the instrument is payable. The term *fixed amount* means an amount that is ascertainable from the face of the instrument. A note payable with a certain percent of interest meets the requirement of a fixed amount because its amount can be determined at the time it is payable or at any time thereafter. The rate of interest may be determined with reference to information that is not contained in the instrument if the information is readily ascertainable by reference to a source, including a statute, described in the instrument.

**3A.** ***Transfer to a holder***

Only a transfer by negotiation can result in a party who obtains an instrument receiving the rights of a holder. Thus, for the government to be a holder, the note would have to have been transferred by negotiation.

**4A.** ***Failure of consideration***

No. The consideration that Durbin received in exchange for his promise to pay consisted of the funds that he was paid when he signed the note, not the quantity or quality of the education that the school provided, or failed to provide, which Durbin bought with those funds.

Answer to Debate This Question in the Reviewing Feature

at the End of the Chapter

***We should eliminate the status of holder in due course for those who possess negotiable instruments.*** No one can deny that HDC status allows holders of negotiable instruments to collect payment even when there has been some underlying misrepresentation or even fraud.  Thus, if holder in due course were eliminated, such misrepresentation or fraud would no longer be as easily avoided by those who perpetuate it.

If we eliminated the possibility of HDC status for negotiable instruments, we would reduce severely the amount of negotiable instruments use in commerce.  Hence, eliminating HDC status would cause a reduction in economic activity and therefore cause a reduced rate of economic growth.  On net, we would be worse off.

Answers to Issue Spotters

at the End of the Chapter

**1A.** ***Sabrina owes $600 to Yale, who asks Sabrina to sign an instrument for the debt. If written on the instrument by Sabrina, which of the following would prevent its negotiability—“I.O.U. $600,” “I promise to pay $600,” or an instruction to the bank stating, “I wish you would pay $600 to Yale”?*** A statement that “I.O.U.” money (or anything else) or an instruction to a bank stating, “I wish you would pay,” would render any instrument nonnegotiable. To be nego­tiable, an instrument must contain an express promise to pay. An I.O.U. is only an acknowledgment of indebted­ness. An order stating, “I wish you would pay,” is not sufficiently precise.

**2A.** ***Rye signs corporate checks for Suchin Corporation. Rye writes a check payable to U-All Company, even though Suchin does not owe U-All anything. Rye signs the check, forges U-All’s indorsement, and cashes the check at Viceroy Bank, the drawee. Does Suchin have any recourse against the bank for the payment? Why or why not?*** No. When a drawer’s employee provides the drawer with the name of a fictitious payee (a payee whom the drawer does not actually intend to have any interest in an in­strument), a forgery of the payee’s name is effec­tive to pass good title to subsequent transferees.

Answers to Questions and Case Problems

**at the End of the Chapter**

**Business Scenarios and Case Problems**

**14–1A . *Negotiable instruments***

For an instrument to be negotiable, it must meet the following requirements:

**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 fixed amount of money.

**5.** Be payable on demand or at a definite time.

**6.** Be payable to order or to bearer, unless it is a check.

The instrument in this case meets the writing requirement in that it is handwritten and on something with a degree of permanence that is transfer­able. The instrument meets the requirement of being signed by the maker, as Muriel Evans’s signature (her name in her handwriting) appears in the body of the instrument. The instrument’s payment is not conditional and contains Muriel Evans’s definite promise to pay. In addition, the sum of $100 is both a fixed amount and payable in money (U.S. currency). Because the instrument is payable on demand and to bearer (Karen Marvin or any holder), the instru­ment is negotiable.

**14-2A. *Material alteration***

No. Material alteration of a negotiable instrument may be a real defense against pay­ment on the instrument. As against a holder in due course, the raising of the amount (material alteration) is only a defense as to the altered amount, and the HDC can recover according to the original tenor of the instru­ment [UCC 3–407(b)]. In this case, however, Williams mate­ri­ally contributed to the al­teration by his negligence in writing the check in pen­cil. Thus, the defense of material alteration was not available to him, and Williams is liable to Boz for the $10,000 [UCC 3–406]. If Williams had written the check in ink, and Stein had altered the amount in such a clever fashion that Boz could take the check with­out notice and be­come an HDC, then Williams would have a real defense against paying $10,000. In the lat­ter case, Boz, as an HDC, could collect only $1,000, the original amount of the check.

**14–3A. *Payable on demand or at a definite time***

No. Novel is not correct. The instrument is a note and Novel is bound to pay it. For an instrument to be negotiable under UCC 3–104, it must meet the following requirements: (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 fixed amount of money, (5) be payable on demand or at a definite time, and (6) be payable to order or to bearer unless it is a check. When no time for payment is stated on an instrument, the instrument is payable on demand.

Applying these principles to the facts in this problem, all of the requirements to establish the instrument as negotiable are met: (1) the instrument is in writing; (2) it is signed by Novel; (3) there are no conditions or promises other than the unconditional promise to pay; (4) the instrument states a fixed amount—$10,000; (5) the instrument does not include a definite repayment date, which means that it is payable on demand; and (6) the instrument is payable to Gallwitz. In the actual case on which this problem is based, the court ruled in favor of Gallwitz for payment of the note.

**14–4A. *Defenses***

When an instrument is transferred by negotiation, the transferee becomes a holder. A holder can become an HDC if the holder takes the instrument for value, in good faith, and without notice of any defects. An HDC takes an instrument free of most defenses against payment that could be asserted against the transferor. Defenses against payment fall into two categories. Universal defenses are good against all holders, including HDCs. Personal defenses are used to avoid payment to an ordinary holder, but not an HDC. Personal defenses include breach of contract, ordinary fraud, and any other defenses that can be asserted to avoid payment on a contract. Between the maker and the payee, a promissory note is a contract to pay money. Defenses that may be asserted by the maker against payment on a note include the personal defenses.

In this problem, Klutz does not qualify as an HDC. Thorbecke signed a note as the maker for most of the price for the purchase of the restaurant. Klutz may have taken Thorbecke’s note for value—at least to the extent that he performed the part of the contract for the sale of the restaurant—but he did not take it in good faith or without notice. He misrepresented his authority to sell the franchise. In other words, under the facts as presented, Klutz appears to have committed fraud in the inducement and to have breached the contract of sale. Thorbecke appears to have reasonably relied on the misrepresentation and to be entitled to damages as a result. Thorbecke may also be justified in asserting these defenses against payment on the note.

In the actual case on which this problem is based, the court issued a decision in Thorbecke’s favor to allow the suit to go to trial to determine whether Klutz misrepresented his authority to transfer the franchise, whether Thorbecke reasonably relied on the misrepresentation, the extent of any damages, and the amount due on the note.

**14–5A . Business Case Problem with Sample Answer—*Negotiation***

A negotiable instrument can be transferred by assignment or by negotiation. An assignment is a transfer of rights by contract. A transfer by assignment to an assignee gives the assignee only those rights that the assignor possessed. Any defenses that can be raised against the assignor can be raised against the assignee. When an instrument is transferred by negotiation, the transferee becomes a holder. A holder receives at least the rights of the previous possessor.

Unlike an assignment, a transfer by negotiation can make it possible for the holder to receive more rights in the instrument than the prior possessor had. A holder who receives greater rights is a holder in due course (HDC) and takes the instrument free of any claims to it and defenses against its payment. Negotiating order instruments requires delivery and indorsement. If a party to whom a negotiable note is made payable signs it and delivers it to a bank, the transfer is a negotiation, and the bank becomes a holder. If the party does not sign it, however, the transfer would be treated as an assignment, and the bank would become an assignee instead of a holder.

In this problem, Argent was the payee of the note and its holder. Argent transferred the note to Wells Fargo without an indorsement. Thus, the transfer was not a negotiation but an assignment. Wells Fargo did not then become a holder of the note but an assignee. As an assignee, the bank acquired only those rights that the lender possessed before the assignment. And any defenses—including fraud in connection with the note—that Ford could assert against the lender could also be asserted by the borrower against the bank. If Argent indorsed the note to Wells Fargo now, after the defendant’s response to the complaint, the bank could become a holder of the note, but it could not become an HDC. One of the requirements for HDC status is that a holder must take an instrument without notice of defenses against payment. The bank could not do this, because it is now aware of the borrower’s defenses.

In the actual case on which this problem is based, the court issued a judgment in Wells Fargo’s favor, and Ford appealed. A state intermediate appellate court reversed the judgment and remanded the case for trial, finding that the bank had failed to prove that it was a holder, an assignee, or even a transferee of the note.

**14–6A. *Indorsements***

Yes, BAC can enforce the note. Under the UCC, the right to enforce an instrument and the ownership of the instrument are two different concepts. The holder of a note is entitled to enforce the instrument even if it is not the owner of the instrument or is in wrongful possession of it. An instrument indorsed in blank can be transferred by delivery alone.

In this problem, the note was indorsed in blank and thus could be transferred by delivery alone. There was no dispute that BAC was in possession of the note. BAC was therefore the holder of the note and entitled to enforce it. There is no additional requirement that BAC prove that it was the owner of the note—whether or not it was the owner is irrelevant—or otherwise how it came into possession of the note.

In the actual case on which this problem is based, the court issued a judgment in BAC’s favor, but on Brock’s appeal, a state intermediate appellate court reversed. On BAC’s appeal, the Court of Appeals of Maryland reversed the lower court’s decision. “BAC is in possession of the Note that is indorsed in blank. BAC is therefore the holder of the Note and \*  \*  \* entitled to enforce it.”

**14–7A. *Bearer instruments***

Yes, U.S. Bank can enforce payment of the note. A bearer instrument is an instrument that does not designate a specific payee, according to UCC 3–109(a). The term bearer refers to a person in possession of an instrument that is payable to bearer or indorsed in blank (that is, indorsed with a signature only) under UCC 1–201(5), and 3–109(a) and (c). This means that the maker or drawer agrees to pay anyone who presents the instrument for payment.

In this problem, Encore Credit Corp., in whose favor Gaitan signed the note to obtain the funds to buy the house, indorsed the note in blank. This made it payable to the bearer, and the bearer could negotiate it by a simple transfer of possession. In other words, with Encore’s indorsement, the note became bearer paper. Because U.S. Bank showed its possession of the note indorsed in blank, the bank was the holder and was thereby entitled to enforce it.

In the actual case on which this problem is based, the court issued a judgment in the bank’s favor, and a state intermediate appellate affirmed, based on the reasoning explained here.

**14–8A. *Transfer by negotiation***

Fannie Mae’s best response to Duong’s argument is that the indorsement was a blank indorsement making the note payable to bearer. Thus, by coming into possession of the note, Fannie Mae became its holder with the ability to enforce it. A bearer instrument is an instrument that does not designate a specific payee. If an instrument is payable to bearer, it is negotiated by delivery—by transfer into another party’s possession. Indorsement is not necessary.

In this problem, Duong signed a note in favor of Country Home Loans, Inc. to obtain a loan to buy a house. The note was indorsed “PAY TO THE ORDER OF [blank space] WITHOUT RECOURSE COUNTRY HOME LOANS, INC.” The Fannie Mae was in possession of the note when Duong defaulted on the payments. Fannie Mae wanted to foreclose on the house and sell it to recover the balance due. Duong argued that Fannie Mae could not enforce the note because the words “to the order of [blank]” in the indorsement made the note incomplete order paper. But a note that does not identify a specific payee and is indorsed in blank is a bearer instrument, negotiable by delivery alone, and enforceable by its holder—here, Fannie Mae.

In the actual case in which this problem is based, Fannie Mae foreclosed on the house and sold it to recover the balance due on the note. Duong filed a petition in a Louisiana state court against Fannie Mae, seeking damages. The court issued a judgment in the defendant’s favor. A state intermediate appellate court rejected Duong’s argument as phrased in this problem and affirmed the lower court’s judgment.

**14–9A. A Question of Ethics—*Promissory notes***

**1.** Barnard is liable on the Trustmark notes as their maker. A maker has primary liability. A primarily liable party is absolutely required to pay an instrument—the liability is not contingent, and a holder of the note (Trustmark, in this case) does not have to proceed against any collateral (the trucks) to enforce payment.

A primarily liable party is unconditionally obligated to pay unless he or she has a valid defense against payment. A discharge of liability can occur under UCC 3–605 if a party’s right of recourse is impaired. A right of recourse is a right to seek reimbursement. An indorser of a note has a right of recourse against prior indorsers, a maker, and accommodation parties. If a holder of the note adversely affects the indorser’s right to seek reimbursement from any of these parties, the indorser is not liable on the note. As noted in the text, this can occur if a holder agrees not to sue a party against whom the indorser has a right of recourse.

Barnard asserted this defense against Trustmark’s claim. The court distributed the liability on both notes between Trustmark and Barnard “on principles of equity,” and Trustmark appealed to a state intermediate appellate court, which reversed the lower court’s decision and remanded the case “to calculate the proper amount owed and enter a judgment for interest and attorney's fees due under the notes.” The appellate court pointed out that “the maker of a note is not entitled to discharge of his obligations because of impairment of collateral by the lender. Instead, under [UCC 3–605], only indorsers and accommodation parties, which Barnard was neither, can obtain a discharge of liability on a note upon a showing of impairment of collateral. Barnard's liability on the Trustmark note was that of a maker. The maker has primary liability, and the obligation to pay is unconditional.”

**2.** Ethics focuses on the application of moral principles in everyday life. Business ethics focuses on the application of these principles in the context of business. An understanding of business ethics is important to the long-run viability of a business, the well being of its owners, operators, officers, directors, and managers, and the welfare of its employees.

In this case, Morgan, Barnard, and Trustmark were each involved in business. If Morgan and Barnard had acted more ethically in their transactions with Trustmark, the lender might have been more accommodating when the notes came due and payment was not forthcoming. In that event, Morgan might not have committed suicide, and Barnard might not have become embroiled in litigation with the lender and the later buyers. If Trustmark had been more diligent in monitoring the deals that it was financing—despite Barnard’s arguments to the contrary, Trustmark was not legally required to review Morgan’s bookkeeping with respect to the trucks covered by the unpaid notes at the heart of this case—Easy Way might have remained a viable concern and Barnard’s credit rating might have remained unaffected.

**Critical Thinking and Writing Assignments**

**14–10A. Business Law Critical Thinking Group Assignment**

**1.** The contention in Stathis’s favor is stated in the question—Gowin did not own any interest in the business because he never paid the $12,500 note. Stathis’s oral waiver was arguably not enough to relieve Gowin of the obligation to pay the amount of the note to the countertop business. The parties should have put the waiver in writing.

**2.** Gowin’s argument is correct. The termination of his interest was improper because compliance with the dates on the note was impossible, given that it was not signed until months after the first payment was due. Because compliance was not possible, the note effectively did not state a date for its payment, and it was a demand note. (The chief reason for regarding the note as a demand note instead of an unenforceable note is that the parties to it regarded it as a binding obligation. Under other circumstances, the note could be construed as incomplete and for that reason invalid.) A demand note does not become overdue until the day after demand is made or the note has been outstanding for an unreasonably long time, whichever occurs first. Here, the note never became overdue because payment was never demanded.