Chapter 22
Nature and Form of Commercial Paper

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. Why commercial paper is important in modern economic systems
2. How the law of commercial paper has developed over the past four hundred years, and what role it plays in economics and finance
3. What the types of commercial paper are, and who the parties to such paper are
4. What is required for paper to be negotiable

Here we begin our examination of commercial paper, documents representing an obligation by one party to pay another money. You are familiar with one kind of commercial paper: a check.

22.1 Introduction to Commercial Paper

LEARNING OBJECTIVES

1. Understand why commercial paper is an important concept in modern finance.
2. Be familiar with the historical development of commercial paper.
3. Recognize how commercial paper is viewed in economics and finance.

The Importance of Commercial Paper

Because commercial paper is a vital invention for the working of our economic system, brief attention to its history and its function as a medium of exchange in economics and finance is appropriate.

The Central Role of Commercial Paper

Commercial paper is the collective term for various financial instruments, or tools, that include checks drawn on commercial banks, drafts (drawn on something other than a bank), certificates of deposit, and notes evidencing a promise to pay. Like money, commercial paper is a medium of exchange, but because it is one step removed from money, difficulties arise that require a series of interlocking rules to protect both sellers and buyers.
To understand the importance of commercial paper, consider the following example. It illustrates a distinction that is critical to the discussion in our four chapters on commercial paper.

Lorna Love runs a tennis club. She orders a truckload of new tennis rackets from Rackets, Inc., a manufacturer. The contract price of the rackets is $100,000. Rackets ships the rackets to Love. Rackets then sells for $90,000 its contract rights (rights to receive the payment from Love of $100,000) to First Bank (see Figure 22.1 "Assignment of Contract Rights"). Unfortunately, the rackets that arrive at Love’s are warped and thus commercially worthless. Rackets files for bankruptcy.

**Figure 22.1 Assignment of Contract Rights**

May the bank collect from Love $100,000, the value of the contract rights it purchased? No. Under the contract rule discussed in Chapter 14 "Third-Party Rights", an assignee—here, the bank—steps into the shoes of the assignor and takes the assigned rights subject to any defense of the obligor, Love. (Here, of course, Love’s defense against paying is that the rackets are worthless.) The result would be the same if Love had given Rackets a nonnegotiable note, which Rackets proceeded to sell to the bank. (By
nonnegotiable we do not mean that the note cannot be sold but only that certain legal requirements, discussed in Section 22.3 "Requirements for Negotiability" of this chapter, have not been met.

Now let us add one fact: In addition to signing a contract, Love gives Rackets a negotiable note in exchange for the rackets, and Rackets sells the note to the bank. By adding that the note is negotiable, the result changes significantly. Because the note is negotiable and because the bank, we assume, bought the note in good faith (i.e., unaware that the rackets were warped), the bank will recover the $100,000 (see Figure 22.2 "Sale of Negotiable Note").

Figure 22.2 Sale of Negotiable Note

The key to the central role that commercial paper plays in modern finance is negotiability. Negotiability means that the paper is freely and unconditionally transferable from one person to another by delivery or by delivery and indorsement. ("Indorsement," not "endorsement," is the spelling used in the UCC, though the latter is more common in nonlegal usage.) Without the ability to pay and finance through commercial paper, the business world would be paralyzed. At bottom, negotiability is
the means by which a person is empowered to transfer to another more than what the transferor himself possesses. In essence, this is the power to convey to a transferee the right in turn to convey clear title, when the original transferor does not have clear title.

**Overview of Chapters on Commercial Paper**

In this chapter, we examine the history and nature of commercial paper and define the types of parties (persons who have an interest in the paper) and the types of instruments. We then proceed to four fundamental issues that must be addressed to determine whether parties such as First Bank, in the preceding example, can collect:

1. Is the paper negotiable? That is, is the paper in the proper form? We explore that issue in this chapter.
2. Was the paper negotiated properly? See Chapter 23 "Negotiation of Commercial Paper".
3. Is the purchaser of the paper a holder in due course? See Chapter 24 "Holder in Due Course and Defenses".
4. Does the maker of the paper have available any defenses against even the holder in due course? See Chapter 24 "Holder in Due Course and Defenses".

In most transactions, especially when the first three questions are answered affirmatively, the purchaser will have little trouble collecting. But when the purchaser is unable to collect, questions of liability arise. These questions, along with termination of liability, are discussed in Chapter 25 "Liability and Discharge". Finally, in Chapter 26 "Legal Aspects of Banking" we examine other legal aspects of banking, including letters of credit and electronic funds transfer.

**History of Commercial Paper  (Section Omitted)**

**KEY TAKEAWAY**

Commercial paper is a medium of exchange used like cash but safer than cash; cash is rarely used today except for small transactions. The key to the success of this invention is the concept of negotiability: through this process, a person can pass on—in most cases—better title to receive payment than he had; thus the transferee of such paper will most likely get paid by the obligor and will not be subject to most defenses of any prior holders. The law of commercial paper has developed over the past four hundred years. It is now the Uniform Commercial Code that governs most commercial paper transactions in the
United States, but federal or international preemption is possible in the future. Commercial paper is important in both economics and finance.

**EXERCISES**

1. If there were no such thing as commercial paper, real or virtual (electronic funds transfers), how would you pay your bills? How did merchants have to pay their bills four hundred years ago?
2. What is it about negotiability that it is the key to the success of commercial paper?
3. How could state law—the UCC—be preempted in regard to commercial paper?

**22.2 Scope of Article 3 and Types of Commercial Paper and Parties**

**LEARNING OBJECTIVES**

1. Understand the scope of Article 3 of the Uniform Commercial Code.
2. Recognize the types of commercial paper: drafts, checks, notes, and certificates of deposit.
3. Give the names of the various parties to commercial paper.

**Scope of Article 3**

Article 3 of the Uniform Commercial Code (UCC) covers commercial paper but explicitly excludes money, documents of title, and investment securities. Documents of title include bills of lading and warehouse receipts and are governed by Article 7 of the UCC. Investment securities are covered by Article 8. Instruments that fall within the scope of Article 3 may also be subject to Article 4 (bank deposits and collections), Article 8 (securities), and Article 9 (secured transactions). If so, the rules of these other articles supersede the provisions of Article 3 to the extent of conflict. Article 3 is a set of general provisions on negotiability; the other articles deal more narrowly with specific transactions or instruments.

**Types of Commercial Paper**

There are four types of commercial paper: drafts, checks, notes, and certificates of deposit.

**Drafts**

A draft is an unconditional written order by one person (the drawer) directing another person (the drawee) to pay a certain sum of money on demand or at a definite time to a named third person (the
payee) or to bearer. The draft is one of the two basic types of commercial paper; the other is the note. As indicated by its definition, the draft is a three-party transaction.

**Parties to a Draft**

The drawer is one who directs a person or an entity, usually a bank, to pay a sum of money stated in an instrument—for example, a person who makes a draft or writes a check. The drawer prepares a document (a form, usually)—the draft—ordering the drawee to remit a stated sum of money to the payee.

The drawee is the person or entity that a draft is directed to and that is ordered to pay the amount stated on it. The most common drawee is a bank. The drawer, drawee, and payee need not be different people; the same person may have different capacities in a single transaction. For example, a drawer (the person asking that payment be made) may also be the payee (the person to whom the payment is to be made). A drawee who signs the draft becomes an acceptor: the drawee pledges to honor the draft as written. To accept, the drawee need only sign her name on the draft, usually vertically on the face, but anywhere will do. Words such as “accepted” or “good” are unnecessary. However, a drawee who indicates that she might refuse to pay will not be held to have accepted. Thus in the archetypal case, the court held that a drawee who signed his name and appended the words “Kiss my foot” did not accept the draft.\(^1\)

The drawer directs the funds to be drawn from—pulled from—the drawee, and the drawee pays the person entitled to payment as directed.

**Types of Drafts**

Drafts can be divided into two broad subcategories: sight drafts and time drafts.

A sight draft calls for payment “on sight,” that is, when presented. Recall from Section 22.1 "Introduction to Commercial Paper" that Lorna Love wished to buy tennis rackets from Rackets, Inc. Suppose Love had the money to pay but did not want to do so before delivery. Rackets, on the other hand, did not want to ship before Love paid. The solution: a sight draft, drawn on Love, to which would be attached an order bill of lading that Rackets received from the trucker when it shipped the rackets. The sight draft and bill of lading go to a bank in Love’s city. When the tennis rackets arrive, the carrier notifies the bank, which presents the draft to Love for payment. When she has done so, the bank gives Love the bill of lading, entitling her to receive the shipment. The bank forwards the payment to Rackets’ bank, which credits Rackets’ account with the purchase amount.
A time draft, not surprisingly, calls for payment on a date specified in the draft. Suppose that Love will not have sufficient cash to pay until she has sold the rackets but that Rackets needs to be paid immediately. The solution: a common form of time draft known as a trade acceptance. Rackets, the seller, draws a draft on Love, who thus becomes a drawee. The draft orders Love to pay the purchase price to the order of Rackets, as payee, on a fixed date. Rackets presents the draft to Love, who accepts it by signing her name. Rackets then can indorse the draft (by signing it) and sell it, at a discount, to its bank or some other financial institution. Rackets thus gets its money right away; the bank may collect from Love on the date specified. See the example of a time draft in Figure 22.3 "A Time Draft".

Figure 22.3 A Time Draft

Drafts in International Trade (section omitted)

Checks

A second type of commercial paper is the common bank check, a special form of draft. Section 3-104(2)(b) of the UCC defines a check as “a draft drawn on a bank and payable on demand.” Postdating a check (putting in a future date) does not invalidate it or change its character as payable on demand. Postdating
simply changes the first time at which the payee may demand payment. Checks are, of course, usually written on paper forms, but a check can be written on anything—a door, a shirt, a rock—though certainly the would-be holder is not obligated to accept it.

Like drafts, checks may be accepted by the drawee bank. Bank acceptance of a check is called certification; the check is said to be certified by stamping the word “certified” on the face of the check. When the check is certified, the bank guarantees that it will honor the check when presented. It can offer this guarantee because it removes from the drawer’s account the face amount of the check and holds it for payment. The payee may demand payment from the bank but not from the drawer or any prior indorser of the check. A certified check is distinct from a cashier’s check. A cashier’s check is drawn on the account of the bank itself and signed by an authorized bank representative in return for a cash payment to it from the customer. The bank guarantees payment of the cashier’s check also.

**Notes**

A note—often called a promissory note—is a written promise to pay a specified sum of money on demand or at a definite time. There are two parties to a note: the maker (promisor), and the payee (promisee). For an example of a promissory note, see Figure 22.4 "A Promissory Note". The maker might execute a promissory note in return for a money loan from a bank or other financial institution or in return for the opportunity to make a purchase on credit.

**Figure 22.4 A Promissory Note**

A fourth type of commercial paper is the certificate of deposit, commonly called a CD. The CD is a written acknowledgment by a bank that it has received money and agrees to repay it at a time specified in the certificate. The first negotiable CD was issued in 1961 by First National City Bank of New York (now
Citibank; it was designed to compete for corporate cash that companies were investing in Treasury notes and other funds. Because CDs are negotiable, they can be traded easily if the holder wants cash, though their price fluctuates with the market.

**Other Parties to Commercial Paper**

In addition to makers, drawees, and payees, there are five other capacities in which one can deal with commercial paper.

**Indorser and Indorsee**

The indorser (also spelled *endorser*) is one who transfers ownership of a negotiable instrument by signing it. A depositor indorses a check when presenting it for deposit by signing it on the back. The bank deposits its own funds, in the amount of the check, to the depositor's account. By indorsing it, the depositor transfers ownership of the check to the bank. The depositor's bank then can present it to the drawer's bank for repayment from the drawer's funds. The indorsee is the one to whom a draft or note is indorsed. When a check is deposited in a bank, the bank is the indorsee.

**Holder**

A holder is “a person in possession of a negotiable that is payable either to bearer, or to an identified person that is the person in possession.”[^2] *Holder* is thus a generic term that embraces several of the specific types of parties already mentioned. An indorsee and a drawee can be holders. But a holder can also be someone unnamed whom the original parties did not contemplate by name—for example, the holder of a bearer note.

**Holder in Due Course**

A holder in due course is a special type of holder who, if certain requirements are met, acquires rights beyond those possessed by the transferor (we alluded to this in describing the significance of Lorna Love's making of a negotiable—as opposed to a nonnegotiable—instrument). We discuss the requirements for a holder in due course in Chapter 24 "Holder in Due Course and Defenses".

**Accommodation Party**

An accommodation party is one who signs a negotiable instrument in order to lend her name to another party to the instrument. It does not matter in what capacity she signs, whether as maker or comaker, drawer or codrawer, or indorser. As a signatory, an accommodation party is always a surety. 

[^2]: *Holder* is thus a generic term that embraces several of the specific types of parties already mentioned.
"Legal Aspects of Banking": a surety is one who guarantees payment if the primarily obligated party fails to pay. The extent of the accommodation party’s liability to pay depends on whether she has added language specifying her purposes in signing. Section 3-416 of the UCC distinguishes between a guaranty of payment and a guaranty of collection. An accommodation party who adds words such as “payment guaranteed” subjects herself to primary liability: she is guaranteeing that she will pay if the principal signatory fails to pay when the instrument is due. But if the accommodation party signs “collection guaranteed,” the holder must first sue the maker and win a court judgment. Only if the judgment is unsatisfied can the holder seek to collect from the accommodation party. When words of guaranty do not specify the type, the law presumes a payment guaranty.

**KEY TAKEAWAY**

The modern law of commercial paper is, in general, covered by UCC Article 3. The two basic types of commercial paper are drafts and notes. The note is a two-party instrument whereby one person (maker) promises to pay money to a second person (payee). The draft is a three-party instrument whereby one person (drawer) directs a second (drawee) to pay money to the third (payee). Drafts may be sight drafts, payable on sight, or they may be time drafts, payable at a date specified on the draft. Checks are drafts drawn on banks. Other parties include indorser and indorsee, holder, holder in due course, and accommodation party.

**EXERCISES**

1. What are the two basic types of commercial paper?
2. What are the two types of drafts?
3. What kind of commercial paper is a check?

**22.3 Requirements for Negotiability**

1. Know what is required for an instrument to be negotiable.
Overview

Whether or not a paper is negotiable is the first of our four major questions, and it is one that nonlawyers must confront. Auditors, retailers, and financial institutions often handle notes and checks and usually must make snap judgments about negotiability. Unless the required elements of Sections 3-103 and 3-104 of the Uniform Commercial Code (UCC) are met, the paper is not negotiable. Thus the paper meets the following criteria:

1. It must be in writing.
2. It must be signed by the maker or drawer.
3. It must be an unconditional promise or order to pay.
4. It must be for a fixed amount in money.
5. It must be payable on demand or at a definite time.
6. It must be payable to order or bearer, unless it is a check.

This definition states the basic premise of a negotiable instrument: the holder must be able to ascertain all essential terms from the face of the instrument.

Analysis of Required Elements

In Writing

Under UCC Section 1-201, “written” or “writing” includes “printing, typewriting or any other intentional reduction to tangible form.” That definition is broad—so broad, in fact, that from time to time the newspapers report checks written on material ranging from a girdle (an Ohio resident wanted to make his tax payment stretch) to granite. Since these are tangible materials, the checks meet the writing requirement. The writing can be made in any medium: ink, pencil, or even spray paint, as was the case with the granite check. Of course, there is a danger in using pencil or an ink that can be erased, since the drawer might be liable for alterations. For example, if you write out in pencil a check for $10 and someone erases your figures and writes in $250, you may lose your right to protest when the bank cashes it.

Signed by the Maker or Drawer

Signature is not limited to the personal handwriting of one’s name. “Any symbol executed or adopted by a party with present intention to authenticate a writing” will serve. That means that a maker or drawer
may make an impression of his signature with a rubber stamp or even an X if he intends that by so doing he has signed. It can be typed or by thumbprint. In some cases, an appropriate letterhead may serve to make the note or draft negotiable without any other signature. Nor does the position of the signature matter. Blackstone Kent’s handwritten note, “Ten days from this note, I, Blackstone Kent, promise to pay $5,000 to the order of Webster Mews,” is sufficient to make the note negotiable, even though there is no subsequent signature. Moreover, the signature may be in a trade name or an assumed name. (Note: special problems arise when an agent signs on behalf of a principal. We consider these problems in Chapter 25 “Liability and Discharge”.)

Unconditional Promise or Order to Pay

Section 3-106(a) of the UCC provides that an instrument is not negotiable if it “states (i) an express condition to payment, (ii) that the promise or order is subject to or governed by another writing, or (iii) that rights or obligations with respect to the promise or order are stated in another writing. A reference to another writing does not of itself make the promise or order conditional.” Under 3-106(b), a promise is not made conditional by “(i) reference to another writing for a statement of rights with respect to collateral, pre-payment, or acceleration, or (ii) because payment is limited to resort to a particular fund or source.” As to “reference to another writing,” see Holly Hill Acres, Ltd. v. Charter Bank of Gainesville, in Section 22.4 “Cases”.

The only permissible promise or order in a negotiable instrument is to pay a sum certain in money. Any other promise or order negates negotiability. The reason for this rule is to prevent an instrument from having an indeterminate value. The usefulness of a negotiable instrument as a substitute for money would be seriously eroded if the instrument’s holder had to investigate whether a stipulation or condition had been met before the thing had any value (i.e., before the obligor’s obligation to pay ripened).

Fixed Amount in Money

The value of the paper must be fixed (specific) so it can be ascertained, and it must be payable in money.

Fixed Amount

The instrument must recite an exact amount of money that is to be paid, although the exact amount need not be expressed in a single figure. For example, the note can state that the principal is $1,000 and the interest is 11.5 percent, without specifying the total amount. Or the note could state the amount in installments: twelve equal installments of $88.25. Or it could state different interest rates before and after
a certain date or depending on whether or not the maker has defaulted; it could be determinable by a formula or by reference to a source described in the instrument. [4] It could permit the maker to take a discount if he pays before a certain date or could assess a penalty if he pays after the date. It could also provide for an attorney’s fees and the costs of collection on default. If it is clear that interest is to be included but no interest amount is set, UCC Section 3-112 provides that it is “payable at the judgment rate in effect at the place of payment of the instrument and at the time interest first accrues.” The fundamental rule is that for any time of payment, the holder must be able to determine, after the appropriate calculations, the amount then payable. See Section 22.4 "Cases", Centerre Bank of Branson v. Campbell, for a case involving the “fixed amount” rule.

**In Money**

Section 1-201(24) of the UCC defines money as “a medium of exchange authorized or adopted by a domestic or foreign government as a part of its currency.” As long as the medium of exchange was such at the time the instrument was made, it is payable in money, even if the medium of exchange has been abolished at the time the instrument is due. Section 3-107 provides the following as to payment in foreign currency: “Unless the instrument otherwise provides, an instrument that states the amount payable in foreign money may be paid in the foreign money or in an equivalent amount in dollars calculated by using the current bank-offered spot rate at the place of payment for the purchase of dollars on the day on which the instrument is paid.”

**Payable on Demand or at a Definite Time**

An instrument that says it is payable on sight is payable on demand, as is one that states no time for payment. “Definite time” may be stated in several ways; it is not necessary to set out a specific date. For example, a note might say that it is payable on or before a stated date, at a fixed period after the date, at a fixed period after sight, at a definite time subject to acceleration, or at a definite time subject to extension at the option of the holder or automatically on or after the occurrence of a particular event. However, if the only time fixed is on the occurrence of a contingent event, the time is not definite, even though the event in fact has already occurred. An example of a valid acceleration clause is the following: “At the option of the holder, this note shall become immediately due and payable in the event that the maker fails to comply with any of the promises contained in this note or to perform any other obligation of the maker to the holder.”
Is the note “Payable ten days after I give birth” negotiable? No, because the date the baby is due is uncertain. Is the note “Payable on January 1, but if the Yankees win the World Series, payable four days earlier” negotiable? Yes: this is a valid acceleration clause attached to a definite date.

One practical difference between a demand instrument and a time instrument is the date on which the statute of limitations begins to run. (A statute of limitations is a limit on the time a creditor has to file a lawsuit to collect the debt.) Section 3-118(1) of the UCC says that a lawsuit to enforce payment at a definite time “must be commenced within six years after the due date” (or the accelerated due date). For demand paper, an action must be brought “within six years after the demand.”

**Payable to Order or Bearer**

An instrument payable to order is one that will be paid to a particular person or organization identifiable in advance. To be payable to order, the instrument must so state, as most ordinarily do, by placing the words “payable to order of” before the name of the payee. An instrument may be payable to the order of the maker, drawer, drawee, or someone else. It also may be payable to the order of two or more payees (together or in the alternative), to an estate, a trust, or a fund (in which case it is payable to the representative, to an office or officer, or to a partnership or unincorporated association). Suppose a printed form says that the instrument is payable both to order and to bearer. In that event, the instrument is payable only to order. However, if the words “to bearer” are handwritten or typewritten, then the instrument can be payable either to order or to bearer.

A negotiable instrument not payable to a particular person must be payable to bearer, meaning to any person who presents it. To be payable to bearer, the instrument may say “payable to bearer” or “to the order of bearer.” It may also say “payable to John Doe or bearer.” Or it may be made payable to cash or the order of cash.

Section 3-104(c) of the UCC excepts checks from the requirement that the instrument be “payable to bearer or order.” Official Comment 2 to that section explains why checks are not required to have the “payable” wording: “Subsection (c) is based on the belief that it is good policy to treat checks, which are payment instruments, as negotiable instruments whether or not they contain the words ‘to the order of.’ These words are almost always pre-printed on the check form....Absence of the quoted words can easily be overlooked and should not affect the rights of holders who may pay money or give credit for a check without being aware that it is not in the conventional form.”
Also affecting this policy is the fact that almost all checks are now read by machines, not human beings. There is no one to see that the printed form does not contain the special words, and the significance of the words is recognized by very few people. In short, it doesn’t matter for checks.

**Missing and Ambiguous Terms**

The rules just stated make up the conditions for negotiability. Dealing with two additional details—missing terms or ambiguous terms—completes the picture. Notwithstanding the presence of readily available form instruments, sometimes people leave words out or draw up confusing documents.

**Incompleteness**

An incomplete instrument—one that is missing an essential element, like the due date or amount—can be signed before being completed if the contents at the time of signing show that the maker or drawer intends it to become a negotiable instrument. Unless the date of an instrument is required to determine when it is payable, an undated instrument can still be negotiable. [3] Otherwise, to be enforceable, the instrument must first be completed—if not by the maker or drawer, then by the holder in accordance with whatever authority he has to do so. [4] See the case presented in Section 22.4 "Cases", Newman v. Manufacturers Nat. Bank of Detroit.

**Ambiguity**

When it is unclear whether the instrument is a note or draft, the holder may treat it as either. Handwritten terms control typewritten and printed terms, and typewritten terms control printed terms. Words control figures, unless the words themselves are ambiguous, in which case the figures control. If the instrument contains a “conspicuous statement, however expressed, to the effect that the promise or order is not negotiable,” its negotiability is destroyed, except for checks, and “an instrument may be a check even though it is described on its face by another term, such as ‘money order.'” [5]

**KEY TAKEAWAY**

If an instrument is not negotiable, it generally will not be acceptable as payment in commercial transactions. The UCC requires that the value of a negotiable instrument be ascertainable on its face, without reference to other documents. Thus the negotiable instrument must be in writing, signed by the maker or drawer, an unconditional promise or order to pay, for a fixed amount in money, payable on
demand or at a definite time, and payable to order or bearer, unless it is a check. If the instrument is incomplete or ambiguous, the UCC provides rules to determine what the instrument means.

## EXERCISES

1. Why does the UCC require that the value of a negotiable instrument be ascertainable from its face, without extrinsic reference?
2. What are the six requirements for an instrument to meet the negotiability test?
3. Why are the words “pay to order” or “pay to bearer” or similar words required on negotiable instruments (except for checks—and why not for checks)?
4. If an instrument is incomplete, is it invalid?
5. [1] Uniform Commercial Code, Section 1-201(39).
9. [5] Uniform Commercial Code, Section 3-104(d); Uniform Commercial Code, Section 3-104(f).

## 22.4 Cases

### Negotiability: Requires Unconditional Promise to Pay

*Holly Hill Acres, Ltd. v. Charter Bank of Gainesville*

314 So.2d 209 (Fla. App. 1975)

Scheb, J.

Appellant/defendant [Holly Hill] appeals from a summary judgment in favor of appellee/plaintiff Bank in a suit wherein the plaintiff Bank sought to foreclose a note and mortgage given by defendant. The plaintiff Bank was the assignee from Rogers and Blythe of a promissory note and purchase money mortgage executed and delivered by the defendant. The note, executed April 28, 1972, contains the following stipulation:

> This note with interest is secured by a mortgage on real estate, of even date herewith, made by the maker hereof in favor of the said payee, and shall be construed and enforced according to the laws of the State of Florida. **The terms of said mortgage are by this reference made a part hereof.** (emphasis added)
Rogers and Blythe assigned the promissory note and mortgage in question to the plaintiff Bank to secure their own note. Plaintiff Bank sued defendant [Holly Hill] and joined Rogers and Blythe as defendants alleging a default on their note as well as a default on defendant's [Holly Hill's] note. Defendant answered incorporating an affirmative defense that fraud on the part of Rogers and Blythe induced the sale which gave rise to the purchase money mortgage. Rogers and Blythe denied the fraud. In opposition to plaintiff Bank's motion for summary judgment, the defendant submitted an affidavit in support of its allegation of fraud on the part of agents of Rogers and Blythe. The trial court held the plaintiff Bank was a holder in due course of the note executed by defendant and entered a summary final judgment against the defendant.

The note having incorporated the terms of the purchase money mortgage was not negotiable. The plaintiff Bank was not a holder in due course, therefore, the defendant was entitled to raise against the plaintiff any defenses which could be raised between the appellant and Rogers and Blythe. Since defendant asserted an affirmative defense of fraud, it was incumbent on the plaintiff to establish the non-existence of any genuine issue of any material fact or the legal insufficiency of defendant's affirmative defense. Having failed to do so, plaintiff was not entitled to a judgment as a matter of law; hence, we reverse.

The note, incorporating by reference the terms of the mortgage, did not contain the unconditional promise to pay required by [the UCC]. Rather, the note falls within the scope of [UCC 3-106(a)(ii)]: “A promise or order is unconditional unless it states that...it is subject to or governed by any other writing.”

Plaintiff Bank relies upon Scott v. Taylor [Florida] 1912 [Citation], as authority for the proposition that its note is negotiable. Scott, however, involved a note which stated: “this note secured by mortgage.” Mere reference to a note being secured by mortgage is a common commercial practice and such reference in itself does not impede the negotiability of the note. There is, however, a significant difference in a note stating that it is “secured by a mortgage” from one which provides, “the terms of said mortgage are by this reference made a part hereof.” In the former instance the note merely refers to a separate agreement which does not impede its negotiability, while in the latter instance the note is rendered non-negotiable.

As a general rule the assignee of a mortgage securing a non-negotiable note, even though a bona fide purchaser for value, takes subject to all defenses available as against the mortgagee. [Citation] Defendant raised the issue of fraud as between himself and other parties to the note, therefore, it was incumbent on
the plaintiff Bank, as movant for a summary judgment, to prove the non-existence of any genuinely triable issue. [Citation]

Accordingly, the entry of a summary final judgment is reversed and the cause remanded for further proceedings.

**CASE QUESTIONS**

1. What was wrong with the promissory note that made it nonnegotiable?
2. How did the note’s nonnegotiability—as determined by the court of appeals—benefit the defendant, Holly Hill?
3. The court determined that the bank was not a holder in due course; on remand, what happens now?

**Negotiability: Requires Fixed Amount of Money**

*Centerrre Bank of Branson v. Campbell*

744 S.W.2d 490 (Mo. App. 1988)

Crow, J.
On or about May 7, 1985, appellants (“the Campbells”) signed the following document:

**Figure 22.5**

**PROMISSORY NOTE**

$11,250.00  May 7, 1985

For value received, the undersigned jointly and severally as principals, promise to pay to the order of Strand Investment Company Eleven Thousand and Two Hundred and Fifty Dollars ($11,250.00) with interest thereon from date at the rate of 14% interest per annum, said principal and interest to be paid in annual installments as follows:

First Year - $3,750.00 + $1,575.00 interest  $5,325.00
Second Year - $3,750.00 + $1,050.00 interest  $4,800.00
Third Year - $3,750.00 + $525.00 interest  $4,275.00

Interest will be payable semi-annually.
Interest may vary with bank rates charged to Strand Investment Company.
If default is made in the payment of any annual installment when due, then the investor’s participation in Notch Real Estate Partnership will be forfeited.
Privilege is given to pay all or any part of this note at any time without penalty.
This note may be used as collateral to obtain funds from a financial institution.

s/ Dowell Campbell  s/ Debbie A. Campbell
Curtis D. Campbell  Debbie A. Campbell
On May 13, 1985, the president and secretary of Strand Investment Company (“Strand”) signed the following provision [see Figure 22.6] on the reverse side of the above [Figure 22.5] document:

Figure 22.6

I hereby Pledge and assign this promissory note in the amount $11,250.00 with recourse, dated this 13th day of May, 1985, to Centerre Bank of Branson, Branson, Mo.

s/ Ben P. Gaines
Strand Investment Co.
Ben P. Gaines, President

Attest:

s/ Betty Hawkins, Secretary, Betty Hawkins

On June 30, 1986, Centerre Bank of Branson (“Centerre”) sued the Campbells. Pertinent to the issues on this appeal, Centerre’s petition averred:

“1. …on [May 7,] 1985, the [Campbells] made and delivered to Strand…their promissory note…and thereby promised to pay to Strand…or its order…($11,250.00) with interest thereon from date at the rate of fourteen percent (14%) per annum; that a copy of said promissory note is attached hereto…and incorporated herein by reference.

2. That thereafter and before maturity, said note was assigned and delivered by Strand…to [Centerre] for valuable consideration and [Centerre] is the owner and holder of said promissory note.”
Centerre’s petition went on to allege that default had been made in payment of the note and that there was an unpaid principal balance of $9,000, plus accrued interest, due thereon. Centerre’s petition prayed for judgment against the Campbells for the unpaid principal and interest.

[The Campbells] aver that the note was given for the purchase of an interest in a limited partnership to be created by Strand, that no limited partnership was thereafter created by Strand, and that by reason thereof there was “a complete and total failure of consideration for the said promissory note.” Consequently, pled the answers, Centerre “should be estopped from asserting a claim against [the Campbells] on said promissory note because of such total failure of consideration for same.”

The cause was tried to the court, all parties having waived trial by jury. At trial, the attorney for the Campbells asked Curtis D. Campbell what the consideration was for the note. Centerre’s attorney interrupted: “We object to any testimony as to the consideration for the note because it’s our position that is not a defense in this lawsuit since the bank is the holder in due course.”...

The trial court entered judgment in favor of Centerre and against the Campbells for $9,000, plus accrued interest and costs. The trial court filed no findings of fact or conclusions of law, none having been requested. The trial court did, however, include in its judgment a finding that Centerre “is a holder in due course of the promissory note sued upon.”

The Campbells appeal, briefing four points. Their first three, taken together, present a single hypothesis of error consisting of these components: (a) the Campbells showed “by clear and convincing evidence a valid and meritorious defense in that there existed a total lack and failure of consideration for the promissory note in question,” (b) Centerre acquired the note subject to such defense in that Centerre was not a holder in due course, as one can be a holder in due course of a note only if the note is a negotiable instrument, and (c) the note was not a negotiable instrument inasmuch as “it failed to state a sum certain due the payee.”...

We have already noted that if Centerre is not a holder in due course, the Campbells can assert the defense of failure of consideration against Centerre to the same degree they could have asserted it against Strand. We have also spelled out that Centerre cannot be a holder in due course if the note is not a negotiable instrument. The pivotal issue, therefore, is whether the provision that interest may vary with bank rates charged to Strand prevents the note from being a negotiable instrument....
Neither side has cited a Missouri case applying [UCC 3-104(a)] to a note containing a provision similar to: “Interest may vary with bank rates charged to Strand.” Our independent research has likewise proven fruitless. There are, however, instructive decisions from other jurisdictions.

In *Taylor v. Roeder*, [Citation, Virginia] (1987), a note provided for interest at “[t]hree percent (3.00%) over Chase Manhattan prime to be adjusted monthly.” A second note provided for interest at “3% over Chase Manhattan prime adjusted monthly.” Applying sections of the Uniform Commercial Code adopted by Virginia identical to [the Missouri UCC], the court held the notes were not negotiable instruments in that the amounts required to satisfy them could not be ascertained without reference to an extrinsic source, the varying prime rate of interest charged by Chase Manhattan Bank.

In *Branch Banking and Trust Co. v. Creasy*, [Citation, North Carolina] (1980), a guaranty agreement provided that the aggregate amount of principal of all indebtedness and liabilities at any one time for which the guarantor would be liable shall not exceed $35,000. The court, emphasizing that to be a negotiable instrument a writing must contain, among other things, an unconditional promise to pay a sum certain in money, held the agreement was not a negotiable instrument. The opinion recited that for the requirement of a sum certain to be met, it is necessary that at the time of payment the holder be able to determine the amount which is then payable from the instrument itself, with any necessary computation, without reference to any outside source. It is essential, said the court, for a negotiable instrument “to bear a definite sum so that subsequent holders may take and transfer the instrument without having to plumb the intricacies of the instrument’s background....

In *A. Alport & Son, Inc. v. Hotel Evans, Inc.*, [Citation] (1970), a note contained the notation “with interest at bank rates.” Applying a section of the Uniform Commercial Code adopted by New York identical to [3-104(a)] the court held the note was not a negotiable instrument in that the amount of interest had to be established by facts outside the instrument.

In the instant case, the Campbells insist that it is impossible to determine from the face of the note the amount due and payable on any payment date, as the note provides that interest may vary with bank rates charged to Strand. Consequently, say the Campbells, the note is not a negotiable instrument, as it does not contain a promise to pay a “sum certain” [UCC 3-104(a)].

Centerre responds that the provision that interest may vary with bank rates charged to Strand is not “directory,” but instead is merely “discretionary.” The argument begs the question. Even if one assumes...
that Strand would elect not to vary the interest charged the Campbells if interest rates charged Strand by banks changed, a holder of the note would have to investigate such facts before determining the amount due on the note at any time of payment. We hold that under 3-104 and 3-106, supra, and the authorities discussed earlier, the provision that interest may vary with bank rates charged to Strand bars the note from being a negotiable instrument, thus no assignee thereof can be a holder in due course. The trial court therefore erred as a matter of law in ruling that Centerre was a holder in due course....

An alert reader will have noticed two other extraordinary features about the note, not mentioned in this opinion. First, the note provides in one place that principal and interest are to be paid in annual installments; in another place it provides that interest will be payable semiannually. Second, there is no acceleration clause providing that if default be made in the payment of any installment when due, then all remaining installments shall become due and payable immediately. It would have thus been arguable that, at time of trial, only the first year's installment of principal and interest was due. No issue is raised, however, regarding any of these matters, and we decline to consider them sua sponte [on our own].

The judgment is reversed and the cause is remanded for a new trial.

**CASE QUESTIONS**

1. What was defective about this note that made it nonnegotiable?
2. What was the consequence to Centerre of the court's determination that the note was nonnegotiable?
3. What did the Campbells give the note for in the first place, and why do they deny liability on it?

**Undated or Incomplete Instruments**

*Newman v. Manufacturers Nat. Bank of Detroit*

*152 N.W.2d 564 (Mich. App. 1967)*

Holbrook, J.

As evidence of [a debt owed to a business associate, Belle Epstein], plaintiff [Marvin Newman in 1955] drew two checks on the National Bank of Detroit, one for $1,000 [about $8,000 in 2010 dollars] and the other for $200 [about $1,600 in 2010 dollars]. The checks were left undated. Plaintiff testified that he paid all but $300 of this debt during the following next 4 years. Thereafter, Belle Epstein told plaintiff that she had destroyed the two checks....
Plaintiff never notified defendant Bank to stop payment on the checks nor that he had issued the checks without filling in the dates. The date line of National Bank of Detroit check forms contained the first 3 numbers of the year but left the last numeral, month and day entries, blank, viz., “Detroit 1, Mich. _ _ 195_ _.” The checks were cashed in Phoenix, Arizona, April 17, 1964, and the date line of each check was completed...They were presented to and paid by Manufacturers National Bank of Detroit, April 22, 1964, under the endorsement of Belle Epstein. The plaintiff protested such payment when he was informed of it about a month later. Defendant Bank denied liability and plaintiff brought suit....

The two checks were dated April 16, 1964. It is true that the dates were completed in pen and ink subsequent to the date of issue. However, this was not known by defendant. Defendant had a right to rely on the dates appearing on the checks as being correct. [UCC 3-113] provides in part as follows:

(a) An instrument may be antedated or postdated.

Also, [UCC 3-114] provides in part as follows:

Typewritten terms prevail over printed terms, handwritten terms prevail over both...

Without notice to the contrary, defendant was within its rights to assume that the dates were proper and filled in by plaintiff or someone authorized by him....

Plaintiff admitted at trial that defendant acted in good faith in honoring the two checks of plaintiff’s in question, and therefore defendant’s good faith is not in issue.

In order to determine if defendant bank’s action in honoring plaintiff’s two checks under the facts present herein constituted an exercise of proper procedure, we turn to article 4 of the UCC...[UCC 4-401(d)] provides as follows:

A bank that in good faith makes payment to a holder may charge the indicated account of its customer according to:

(1) the original tenor of his altered item; or

(2) the tenor of his completed item, even though the bank knows the item has been completed unless the bank has notice that the completion was improper.

...[W]e conclude it was shown that two checks were issued by plaintiff in 1955, filled out but for the dates which were subsequently completed by the payee or someone else to read April 16, 1964, and presented to defendant bank for payment, April 22, 1964. Applying the rules set forth in the UCC as quoted herein, the
action of the defendant bank in honoring plaintiff's checks was in good faith and in accord with the standard of care required under the UCC.

Since we have determined that there was no liability under the UCC, plaintiff cannot succeed on this appeal.

Affirmed.

**CASE QUESTIONS**

1. Why does handwriting control over printing or typing on negotiable instruments?
2. How could the plaintiff have protected himself from liability in this case?

**22.5 Summary and Exercises**

**Summary**

Commercial paper is the collective term for a variety of instruments—including checks, certificates of deposit, and notes—that are used to pay for goods; commercial paper is basically a contract to pay money. The key to the central role of commercial paper is negotiability, the means by which a person is empowered to transfer to another more than what the transferor himself possesses. The law regulating negotiability is Article 3 of the Universal Commercial Code.

Commercial paper can be divided into two basic types: the draft and the note. A draft is a document prepared by a drawer ordering the drawee to remit a stated sum of money to the payee. Drafts can be subdivided into two categories: sight drafts and time drafts. A note is a written promise to pay a specified sum of money on demand or at a definite time.

A special form of draft is the common bank check, a draft drawn on a bank and payable on demand. A special form of note is the certificate of deposit, a written acknowledgment by a bank that it has received money and agrees to repay it at a time specified in the certificate.

In addition to drawers, makers, drawees, and payees, one can deal with commercial paper in five other capacities: as indorsers, indorsees, holders, holders in due course, and accommodation parties.

A holder of a negotiable instrument must be able to ascertain all essential terms from its face. These terms are that the instrument (1) be in writing, (2) be signed by the maker or drawer, (3) contain an unconditional promise or order to pay (4) a sum certain in money, (5) be payable on demand or at a
definite time, and (6) be payable to order or to bearer. If one of these terms is missing, the document is not negotiable, unless it is filled in before being negotiated according to authority given.

**EXERCISES**

1. Golf Inc. manufactures golf balls. Jack orders 1,000 balls from Golf and promises to pay $4,000 two weeks after delivery. Golf Inc. delivers the balls and assigns its contract rights to First Bank for $3,500. Golf Inc. then declares bankruptcy. May First Bank collect $3,500 from Jack? Explain.

2. Assume in problem 1 that Jack gives Golf Inc. a nonnegotiable note for $3,500 and Golf sells the note to the bank shortly after delivering the balls. May the bank collect the $3,500? Would the result be different if the note were negotiable? Explain.

3. George decides to purchase a new stereo system on credit. He signs two documents—a contract and a note. The note states that it is given “in payment for the stereo” and “if stereo is not delivered by July 2, the note is cancelled.” Is the note negotiable? Explain.

4. Is the following instrument a note, check, or draft? Explain.

   **Figure 22.7**

   To: Robert Canon
   
   December 14, 2012
   
   Five days after date pay to the order of: Frances Sharp the sum of $500.

   Signed: Dolores Jackson

5. State whether the following provisions in an instrument otherwise in the proper form make the instrument nonnegotiable and explain why:
a. A note stating, “This note is secured by a mortgage of the same date on property located at 1436 Dayton Street, Jameson, New York”

b. A note for $25,000 payable in twenty installments of $1,250 each that provides, “In the event the maker dies all unpaid installments are cancelled”

c. An instrument reading, “I.O.U., Rachel Donaldson, $3,000”

d. A note reading, “I promise to pay Rachel Donaldson $3,000”

e. A note stating, “In accordance with our telephone conversation of January 7th, I promise to pay Sally Wilkenson or order $1,500”

f. An undated note for $1,500 “payable one year after date”

g. A note for $1,500 “payable to the order of Marty Dooley, six months after Nick Solster’s death”

h. A note for $18,000 payable in regular installments also stating, “In the event any installment is not made as provided here, the entire amount remaining unpaid may become due immediately”

Lou enters into a contract to buy Alan’s car and gives Alan an instrument that states, “This acknowledges my debt to Alan in the amount of $10,000 that I owe on my purchase of the 2008 Saturn automobile I bought from him today.” Alan assigns the note to Judy for $8,000. Alan had represented to Lou that the car had 20,000 miles on it, but when Lou discovered the car had 120,000 miles he refused to make further payments on the note. Can Judy successfully collect from Lou? Explain.

The same facts as above are true, but the instrument Lou delivered to Alan reads, “I promise to pay to Alan or order $10,000 that I owe on my purchase of the 2008 automobile I bought from him today.” Can Judy successfully collect from Lou? Explain.

Joe Mallen, of Sequim, Washington, was angry after being cited by a US Fish and Wildlife Service for walking his dog without a leash in a federal bird refuge. He was also aggravated with his local bank because it held an out-of-state check made out to Mallen for ten days before honoring it. To vent his anger at both, Mallen spray painted a twenty-five-pound rock from his front yard with three coats of white paint, and with red paint, spelled out his account number, the bank’s name, the payee, his leash law citation number, and his signature. Should the US District Court in Seattle—the payee—attempt to cash the rock, would it be good? Explain. [1]

Raul Castana purchased a new stereo system from Eddington Electronics Store. He wrote a check on his account at Silver Bank in the amount of $1,200 and gave it to Electronics’ clerk. David Eddington, the
store owner, stamped the back of the check with his rubber indorsement stamp, and then wrote, “Pay to the order of City Water,” and he mailed it to City Water to pay the utility bill. Designate the parties to this instrument using the vocabulary discussed in this chapter.

Would Castana’s signed note made out to Eddington Electronics Store be negotiable if it read, “I promise to pay Eddington’s or order $1,200 on or before May 1, 2012, but only if the stereo I bought from them works to my satisfaction”? Explain. And—disregarding negotiability for a moment—designate the parties to this instrument using the vocabulary discussed in this chapter.

Chapter 23
Negotiation of Commercial Paper

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The distinction between transfer and negotiation of commercial paper
2. The liability of a person who transfers paper
3. The types of indorsements and their effects
4. Special problems that arise with forged indorsements

In the previous chapter, we took up the requirements for paper to be negotiable. Here we take up negotiation.

23.1 Transfer and Negotiation of Commercial Paper

LEARNING OBJECTIVES

1. Understand what a transfer of commercial paper is.
2. Recognize the rights and liabilities of transferees and the liabilities of transferors.
3. Know how a transfer becomes a negotiation payable to order or to bearer.

Definitions, Rights, and Liabilities

Transfer means physical delivery of any instrument—negotiable or not—intending to pass title. Section 3-203(a) of the Uniform Commercial Code (UCC) provides that “an instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument.”

Negotiation and Holder

Section 3-201(a) of the UCC defines negotiation as “a transfer of possession, whether voluntary or involuntary, of an instrument to a person who thereby becomes its holder if possession is obtained from a person other than the issuer of the instrument.” A holder is defined in Section 1-201(2) as “a person who is in possession of an instrument drawn, issued, or indorsed to him or his order or to bearer or in blank”
(“in blank” means that no indorsement is required for negotiation). The original issuing or making of an instrument is not negotiation, though a holder can be the beneficiary of either a transfer or a negotiation. The Official Comment to 3-201(a) is helpful:

*A person can become holder of an instrument when the instrument is issued to that person, or the status of holder can arise as the result of an event that occurs after issuance. “Negotiation” is the term used in article 3 to describe this post-issuance event. Normally, negotiation occurs as the result of a voluntary transfer of possession of an instrument by a holder to another person who becomes the holder as a result of the transfer. Negotiation always requires a change in possession of the instrument because nobody can be a holder without possessing the instrument, either directly or through an agent. But in some cases the transfer of possession is involuntary and in some cases the person transferring possession is not a holder.…[S]ubsection (a) states that negotiation can occur by an involuntary transfer of possession. For example, if an instrument is payable to bearer and it is stolen by Thief or is found by Finder, Thief or Finder becomes the holder of the instrument when possession is obtained. In this case there is an involuntary transfer of possession that results in negotiation to Thief or Finder.*[^1]

In other words, to qualify as a holder, a person must possess an instrument that runs to her. An instrument “runs” to a person if (1) it has been issued to her or (2) it has been transferred to her by negotiation (negotiation is the “post-issuance event” cited in the comment). Commercially speaking, the status of the immediate person to whom the instrument was issued (the payee) is not very interesting; the thing of interest is whether the instrument is passed on by the payee after possession, through negotiation. Yes, the payee of an instrument is a holder, and can be a holder in due course, but the crux of negotiable instruments involves taking an instrument free of defenses that might be claimed by anybody against paying on the instrument; the payee would know of defenses, usually, so—as the comment puts it—“use of the holder-in-due-course doctrine by the payee of an instrument is not the normal situation….rather, the holder in due course is an immediate or remote transferee of the payee.”[^2]

**Liability of Transferors**

We discuss liability in [Chapter 25 "Liability and Discharge".](#) However, a brief introduction to liability will help in understanding the types of indorsements discussed in this chapter. There are two types of liability affecting transferors: contract liability and warranty liability.
Contract Liability

Persons who sign the instrument—that is, makers, acceptors, drawers, indorsers—have signed a contract and are subject to contract liabilities. Drafts (checks) and notes are, after all, contracts. Makers and acceptors are primary parties and are unconditionally liable to pay the instrument. Drawers and indorsers are secondary parties and are conditionally liable. The conditions creating liability—that is, presentment, dishonor, and notice—are discussed in Chapter 25 "Liability and Discharge".

Warranty Liability

The transferor’s contract liability is limited. It applies only to those who sign and only if certain additional conditions are met and, as will be discussed, can even be disclaimed. Consequently, a holder who has not been paid often must resort to a suit based on one of five warranties. These warranties are implied by law; UCC, Section 3-416, details them:

(A) A person who transfers an instrument for consideration warrants all of the following to the transferee and, if the transfer is by indorsement, to any subsequent transferee:

(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 which can be asserted against the warrantor.
(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.

Breach of one of these warranties must be proven at trial if there is no general contract liability.

Liability of Transferees

The transferee takes by assignment; as an assignee, the new owner of the instrument has only those rights held by the assignor. Claims that could be asserted by third parties against the assignor can be asserted against the assignee. A negotiable instrument can be transferred in this sense without being negotiated. A payee, for example, might fail to meet all the requirements of negotiation; in that event, the instrument might wind up being merely transferred (assigned). When all requirements of negotiability and negotiation have been met, the buyer is a holder and may (if a holder in due course—see Chapter 24 "Holder in Due Course and Defenses") collect on the instrument without having to prove anything more.
But if the instrument was not properly negotiated, the purchaser is at most a transferee and cannot collect if defenses are available, even if the paper itself is negotiable.

**How Negotiation Is Accomplished**

Negotiation can occur with either bearer paper or order paper.

**Negotiation of Instrument Payable to Bearer**

An instrument payable to bearer—bearer paper—can be negotiated simply by delivering it to the transferee (see Figure 23.1 "Negotiation of Bearer Paper"; recall that “Lorna Love” is the proprietor of a tennis club introduced in Chapter 22 "Nature and Form of Commercial Paper"): bearer paper runs to whoever is in possession of it, even a thief. Despite this simple rule, the purchaser of the instrument may require an indorsement on some bearer paper anyway. You may have noticed that sometimes you are requested to indorse your own check when you make it out to cash. That is because the indorsement increases the liability of the indorser if the holder is unable to collect. *Chung v. New York Racing Association* (Section 23.4 "Cases") deals with issues involving bearer paper.

*Figure 23.1 Negotiation of Bearer Paper*

**Negotiation of Instrument Payable to Order**

Negotiation is usually voluntary, and the issuer usually directs payment “to order”—that is, to someone’s order, originally the payee. Order paper is this negotiable instrument that by its term is payable to a specified person or his assignee. If it is to continue its course through the channels of commerce, it must be indorsed—signed, usually on the back—by the payee and passed on to the transferee. Continuing with the example used in Chapter 22 "Nature and Form of Commercial Paper", Rackets, Inc. (the payee) negotiates Lorna Love’s check (Lorna is the issuer or drawer) drawn to the order of Rackets when an agent of Rackets “signs” the company’s name on the reverse of the check and passes it to the indorsee, such as the bank or someone to whom Rackets owed money. (A company’s signature is usually a rubber stamp for mere deposit, but an agent can sign the company name and direct the instrument elsewhere.) The transferee is a holder (see Figure 23.2 "Negotiation of Order Paper"). Had Rackets neglected to indorse
the check, the transferee, though in physical possession, would not be a holder. Issues regarding indorsement are discussed in Section 23.2 "Indorsements".

**Figure 23.2 Negotiation of Order Paper**

![Figure 23.2 Negotiation of Order Paper](image)

### KEY TAKEAWAY

A transfer is the physical delivery of an instrument with the intention to pass title—the right to enforce it. A mere transferee stands in the transferor’s shoes and takes the instrument subject to all the claims and defenses against paying it that burdened it when the transferor delivered it. Negotiation is a special type of transfer—voluntary or involuntary—to a holder. A holder is a person who has an instrument drawn, issued, or indorsed to him or his order or to bearer or in blank. If the instrument is order paper, negotiation is accomplished by indorsement and delivery to the next holder; if it is bearer paper or blank paper, delivery alone accomplishes negotiation. Transferors incur two types of liability: those who sign the instrument are contractually liable; those who sign or those who do not sign are liable to the transferee in warranty.

### EXERCISES

1. What is a transfer of commercial paper, and what rights and liabilities has the transferee?
2. What is a negotiation of commercial paper?
3. What is a holder?
4. How is bearer paper negotiated?
5. How is order paper negotiated?

### 23.2 Indorsements

#### LEARNING OBJECTIVES

1. Understand the meaning of indorsement and its formal requirements.
2. Know the effects of various types of indorsements: no indorsement, partial, blank, special, restrictive, conditional, qualified.

Definition and Formal Requirements of Indorsement

Definition

Most commonly, paper is transferred by indorsement. The indorsement is evidence that the indorser intended the instrument to move along in the channels of commerce. An indorsement is defined by UCC Section 3-204(a) as

*a signature, other than that of a signer as maker, drawer, or acceptor, that alone or accompanied by other words is made on an instrument for the purpose of (i) negotiating the instrument, (ii) restricting payment of the instrument, or (iii) incurring indorser's liability on the instrument, but regardless of the intent of the signer, a signature and its accompanying words is an indorsement unless the accompanying words, terms of the instrument, place of the signature, or other circumstances unambiguously indicated that the signature was made for a purpose other than indorsement.*

Placement of Indorsement

*Indorse (or endorse) literally means “on the back of,” as fish, say, have dorsal fins—fins on their backs. Usually indorsements are on the back of the instrument, but an indorsement could be on a piece of paper affixed to the instrument. Such an attachment is called an allonge—it comes along with the instrument (UCC, Section 3-204(a)). There are rules about where indorsements are placed. The Expedited Funds Availability Act was enacted in 1987 by Congress to standardize holding periods on deposits made to commercial banks and to regulate institutions’ use of deposit holds—that is, how soon customers can access the money after they have deposited a check in the bank. The Federal Reserve Board subsequently adopted “Regulation CC, Check Endorsement Standards” to improve funds availability and expedite the return of checks. See Figure 23.3 "Indorsement Standard".*
As shown in Figure 23.3 "Indorsement Standard", specific implementing guidelines define criteria for the placement, content, and ink color of endorsement areas on the back of checks for the depositary bank (bank of first deposit), subsequent indorsers (paying banks), and corporate or payee indorsers. Indorsements must be made within 1½ inches of the trailing (left) edge of the back of the check; remaining space is for bank indorsements. There is no penalty for violating the standard—it is a guideline.

The abbreviation “MICR” stands for magnetic ink character recognition. The “clear band” is a section of the back of the check that is not supposed to be intruded upon with any magnetic (machine-readable) printing that would interfere with machine reading on the front side (the bank routing numbers).

Sometimes an indorser adds words intended to strengthen the indorsement; for example, “I hereby assign all my right, title, and interest in this note to Carl Carpenter.” Words of assignment such as these and also words of condition, waiver, guaranty, limitation, or disclaimer of liability do not negate the effect of an indorsement.
**Misspelled or Incorrect Indorsements**

When the instrument is made payable to a person under a misspelled name (or in a name other than his own), he may indorse in the wrong name or the right one or both. It is safer to sign in both names, and the purchaser of the instrument may demand a signature in both names (UCC, Section 3-204(d)).

**Various Indorsements and Their Effects**

A holder can indorse in a variety of ways; indorsements are not identical and have different effects.

**No Indorsement**

If the instrument requires a signature, transfer without indorsement is an assignment only. Bearer paper does not require indorsement, so it can be negotiated simply by delivering it to the transferee, who becomes a holder. The transferor has no contract liability on the instrument, however, because he has not signed it. He does remain liable on the warranties, but only to the person who receives the paper, not to subsequent transferees.

Because it is common practice for a depository bank (the bank into which a person makes a deposit) to receive unindorsed checks under so-called lockbox agreements from customers who receive a high volume of checks, a customer who is a holder can deposit a check or other instrument for credit to his account without indorsement. Section 4-205(1) of the UCC provides that a “depositary bank becomes a holder...at the time it receives the item for collection if the customer at the time of delivery was a holder, whether or not the customer indorses the item.”

**Partial Indorsement**

To be effective as negotiation, an indorsement must convey the entire instrument. An indorsement that purports to convey only a portion of the sum still due amounts to a partial assignment. If Rackets’ agent signs the check “Rackets, Inc.” together with the words “Pay half to City Water, /s/ Agent” and delivers the check to City Water, that does not operate as an indorsement, and City Water becomes an assignee, not a holder.

**Blank Indorsement**

A blank indorsement consists of the indorser’s signature alone (see Figure 23.4 "Forms of Endorsement", left). A blank indorsement converts the instrument into paper closely akin to cash. Since the indorsement does not specify to whom the instrument is to be paid, it is treated like bearer paper—assuming, of course,
that the first indorser is the person to whom the instrument was payable originally. A paper with blank indorsement may be negotiated by delivery alone, until such time as a holder converts it into a *special indorsement* (discussed next) by writing over the signature any terms consistent with the indorsement. For example, a check indorsed by the payee (signed on the back) may be passed from one person to another and cashed in by any of them.

*Figure 23.4 Forms of Endorsement*

A blank indorsement creates conditional contract liability in the indorser: he is liable to pay if the paper is dishonored. The blank indorser also has warranty liability toward subsequent holders.

**Special Indorsement**

A special indorsement, sometimes known as an “indorsement in full,” names the transferee-holder. The payee of a check can indorse it over to a third party by writing “Pay to the order of [name of the third party]” and then signing his name (see *Figure 23.4 Forms of Endorsement*, center). Once specially indorsed, the check (or other instrument) can be negotiated further only when the special indorsee adds his own signature. A holder may convert a blank indorsement into a special indorsement by writing above the signature of the indorser words of a contractual nature consistent with the character of the instrument.

So, for example, Lorna Love’s check to Rackets, Inc., indorsed in blank (signed by its agent or stamped with Rackets’ indorsement stamp—its name alone) and handed to City Water, is not very safe: it is bearer paper. If the check fell onto the floor, anybody could be a holder and cash it. It can easily be converted into a check with special indorsement: City Water’s clerk need only add the words “Pay City Water” above Rackets’ indorsement. (The magic words of negotiability—“pay to order of bearer”—are not required in an indorsement.) Before doing so, City Water could have negotiated it simply by giving it to someone (again, a blank indorsement acts as bearer paper). After converting it to a special indorsement, City Water must
indorse it in order to transfer it by negotiation to someone else. The liabilities of a special indorser are the same as those of a blank indorser.

The dichotomy here of indorsement in blank or special indorsement is the indorser’s way of indicating how the instrument can be subsequently negotiated: with or without further indorsing.

**Restrictive Indorsement**

A restrictive indorsement attempts to limit payment to a particular person or otherwise prohibit further transfer or negotiation. We say “attempts to limit” because a restrictive indorsement is generally invalid. Section 3-206(a) of the UCC provides that an attempt to limit payment to a particular person or prohibit further transfer “is not effective.” Nor is “[a]n indorsement stating a condition to the right of the indorsee to receive payment”; the restriction may be disregarded. However, two legitimate restrictive indorsements are valid: collection indorsements and trust indorsements. *Wisner Elevator Company, Inc. v. Richland State Bank* ([Section 23.4 "Cases") deals with conditional and restrictive indorsements.

**Collection Indorsement**

It is very common for people and businesses to mail checks to their bank for deposit to their accounts. Sometimes mail goes astray or gets stolen. Surely it must be permissible for the customer to safeguard the check by restricting its use to depositing it in her account. A collection indorsement, such as “For deposit” or “For collection,” is effective. Section 3-206(c) of the UCC provides that anybody other than a bank who purchases the instrument with such an indorsement converts the instrument—effectively steals it. A depositary bank that takes it must deposit it as directed, or the bank has converted it. A payor bank that is also the depositary bank that takes the instrument for immediate payment over the counter converts it: the check cannot be cashed; it must be deposited (see *Figure 23.4 "Forms of Endorsement"*).

To illustrate, suppose that Kate Jones indorses her paycheck “For deposit only, Kate Jones,” which is by far the most common type of restrictive indorsement (see *Figure 23.4 "Forms of Endorsement", right). A thief steals the check, indorses his name below the restrictive indorsement, and deposits the check in Last Bank, where he has an account, or cashes it. The check moves through the collection process to Second Bank and then to First Bank, which pays the check. Kate has the right to recover only from Last Bank, which did not properly honor the indorsement by depositing the payment in her account.
**Trust Indorsement**

A second legitimate restrictive indorsement is indorsement in trust, called a trust indorsement (sometimes *agency indorsement*). Suppose Paul Payee owes Carlene Creditor a debt. Payee indorses a check drawn to him by a third party, “Pay to Tina Attorney in trust for Carlene Creditor.” Attorney indorses in blank and delivers it to (a) a holder for value, (b) a depository bank for collection, or (c) a payor bank for payment. In each case, these takers can safely pay Attorney so long as they have no notice under Section 3-307 of the UCC of any breach of fiduciary duty that Attorney may be committing. For example, under Section 3-307(b), these takers have notice of a breach of trust if the check was taken in any transaction known by the taker to be for Attorney’s personal benefit. Subsequent transferees of the check from the holder or depository bank are not affected by the restriction unless they have knowledge that Attorney dealt with the check in breach of trust (adapted from UCC, Section 3-206, Official Comment 4). (Of course Attorney should not indorse in blank; she should indorse “Tina Attorney, in trust for Carlene Creditor” and deposit the check in her trust account.)

The dichotomy here between restrictive and unrestrictive indorsements is the indorser’s way of showing to what use the instrument may be put.

**Conditional Indorsement**

An indorser might want to condition the negotiation of an instrument upon some event, such as “Pay Carla Green if she finishes painting my house by July 15.” Such a conditional indorsement is generally ineffective: the UCC, Section 3-206(b), says a person paying for value can disregard the condition without liability.

**Qualified Indorsement**

An indorser can limit his liability by making a qualified indorsement. The usual qualified indorsement consists of the words “without recourse,” which mean that the indorser has no contract liability to subsequent holders if a maker or drawee defaults. A qualified indorsement does not impair negotiability. The qualification must be in writing by signature on the instrument itself. By disclaiming contract liability, the qualified indorser also limits his warranty liabilities, though he does not eliminate them. Section 3-415(a) of the UCC narrows the indorser’s warranty that no defense of any party is good against the indorser. In its place, the qualified indorser warrants merely that he has no knowledge of any defense.
“Without recourse” indorsements can have a practical impact on the balance sheet. A company holding a promissory note can obtain cash by discounting it—indorsing it over to a bank for maturity value less the bank’s discount. As an indorser, however, the company remains liable to pay the amount to subsequent holders should the maker default at maturity. The balance sheet must reflect this possibility as a contingent liability. However, if the note is indorsed without recourse, the company need not account for any possible default of the maker as a contingent liability.

The dichotomy here between qualified and unqualified indorsements is the indorser’s way of indicating what liability she is willing to incur to subsequent holders.

**KEY TAKEAWAY**

An indorsement is, usually, the signature of an instrument’s holder on the back of the instrument, indicating an intention that the instrument should proceed through the channels of commerce. The Federal Reserve Board has recommendations for how instruments should be indorsed to speed machine reading of them. Indorsements are either blank or special; they are either restrictive or nonrestrictive; and they are either qualified or unqualified. These pairings show the indorser’s intention as to how further negotiation may be accomplished, to what uses the instrument may be put, and what liability the indorser is willing to assume.

**EXERCISES**

1. If an instrument is not indorsed according to Federal Reserve Board standards, is it still valid?
2. Suppose that Indorsee signs an instrument in blank and drops it. Suppose that the instrument is found by Finder and that Finder delivers it to Third Person with the intention to sell it. Is this successful negotiation?
3. Why would a person make a restrictive indorsement? A qualified indorsement?

**23.3 Problems and Issues in Negotiation**

**LEARNING OBJECTIVES**

1. Recognize under what circumstances a negotiation is subject to rescission.
2. Know the effect of reacquisition of an instrument.
3. Understand how instruments made payable to two or more persons are negotiated.
Understand how the UCC treats forged indorsements, imposters, and other signatures in the name of the payee.

Common Issues Arising in Negotiation of Commercial Paper (section omitted)

23.4 Cases

Bearer Paper

(Note: this is a trial court’s opinion.)

Chung v. New York Racing Ass’n

Gartner, J.

A published news article recently reported that an investigation into possible money laundering being conducted through the racetracks operated by the defendant New York Racing Association was prompted by a small-time money laundering case in which a Queens bank robber used stolen money to purchase betting vouchers and then exchanged the vouchers for clean cash. [Citation] The instant case does not involve any such question of wrongdoing, but does raise a novel legal issue regarding the negotiability of those same vouchers when their possession is obtained by a thief or finder. The defendant concedes that “there are no cases on point.”

The defendant is a private stock corporation incorporated and organized in New York as a non-profit racing association pursuant to [New York law]. The defendant owns and operates New York’s largest thoroughbred racetracks—Belmont Park Racetrack, Aqueduct Racetrack, and Saratoga Racetrack—where it stages thoroughbred horse races and conducts pari-mutuel wagering on them pursuant to a franchise granted to the defendant by the State of New York.

The plaintiff was a Belmont Park Racetrack horse player. He attended the track and purchased from the defendant a voucher for use in SAMS machines. As explained in [Citation]:

In addition to accepting bets placed at parimutuel facility windows staffed by facility employees, [some] facilities use SAMS. SAMS are automated machines which permit a bettor to enter his bet by inserting money, vouchers or credit cards into the machine, thereby enabling him to select the number or combination he wishes to purchase. A ticket is issued showing those numbers. [1]
When a voucher is utilized for the purpose of placing a bet at a SAMS machine, the SAMS machine, after deducting the amount bet by the horse player during the particular transaction, provides the horse player with, in addition to his betting ticket(s), a new voucher showing the remaining balance left on the voucher.

In the instant case, the unfortunate horse player departed the SAMS machine with his betting tickets, but without his new voucher—showing thousands of dollars in remaining value—which he inadvertently left sitting in the SAMS machine. Within several minutes he realized his mistake and hurried back to the SAMS machine, only to find the voucher gone. He immediately notified a security guard. The defendant’s personnel thereafter quickly confirmed the plaintiff as the original purchaser of the lost voucher. The defendant placed a computerized “stop” on the voucher. However, whoever had happened upon the voucher in the SAMS machine and taken it had acted even more quickly: the voucher had been brought to a nearby track window and “cashed out” within a minute or so of the plaintiff having mistakenly left it in the SAMS machine.

The plaintiff now sues the defendant, contending that the defendant should be liable for having failed to “provide any minimal protection to its customers” in checking the identity and ownership of vouchers prior to permitting their “cash out.” The defendant, in response, contends that the voucher consists of “bearer paper,” negotiable by anyone having possession, and that it is under no obligation to purchasers of vouchers to provide any such identity or ownership checks.

As opposed to instruments such as ordinary checks, which are typically made payable to the order of a specific person and are therefore known as “order paper,” bearer paper is payable to the “bearer,” i.e., whoever walks in carrying (or “bearing”) the instrument. Pursuant to [New York’s UCC] “[a]n instrument is payable to bearer when by its terms it is payable to...(c) ‘cash’ or the order of ‘cash’, or any other indication which does not purport to designate a specific payee.”

Each New York Racing Association voucher is labeled “Cash Voucher.” Each voucher contains the legend “Bet Against the Value or Exchange for Cash.” Each voucher is also encoded with certain computer symbols which are readable by SAMS machines. The vouchers do by their terms constitute “bearer paper.” There is no doubt that under the [1990 Revision] Model Uniform Commercial Code the defendant would be a “holder in due course” of the voucher, deemed to have taken it free from all defenses that could be

*Consider theft of bearer instruments…[T]he thief can make his or her transferee a holder simply by transfer to one who gives value in good faith. If the thief’s transferee cashes the check and so gives value in good faith and without notice of any defense, that transferee will be a holder in due course under 3-302, free of all claims to the instrument on the part…of any person and free of all personal defenses of any prior party. Therefore, the holder in due course will not be liable in conversion to the true owner….Of course, the owner of the check will have a good cause of action against the thief, but no other cause of action…. If an instrument is payable to bearer…the possessor of the instrument will be a holder and, if he meets the other tests, a holder in due course. This is so even though the instrument may have passed through the hands of a thief; the holder in due course is one of the few purchasers in Anglo-Saxon jurisprudence who may derive a good title from a chain of title that includes a thief in its links.*

However, the Model Uniform Commercial Code in its present form is not in effect in New York. [2] In 1990, the National Conference of Commissioners on Uniform State Laws and the American Law Institute approved a revised Article 3. This revised Article 3 has never been enacted in New York. Comment 1 to § 3-201 of the [1990] Uniform Commercial Code, commenting on the difference between it and its predecessor (which is still in effect in New York), states:

*A person can become holder of an instrument…as the result of an event that occurs after issuance. “Negotiation” is the term used in Article 3 to describe this post-issuance event….In defining “negotiation” former Section 3-202(1) used the word “transfer,” an undefined term, and “delivery,” defined in Section 1-201(14) to mean voluntary change of possession. Instead, subsections (a) and (b) [now] use the term “transfer of possession,” and subsection (a) states that negotiation can occur by an involuntary transfer of possession. For example, if an instrument is payable to bearer and it is stolen by Thief or is found by Finder, Thief or Finder becomes the holder of the instrument when possession is obtained. In this case there is an involuntary transfer of possession that results in negotiation to Thief or Finder.*
Thus, it would initially appear that under the prior Model Uniform Commercial Code, still in effect in New York, a thief or finder of bearer paper, as the recipient of an involuntary transfer, could not become a “holder,” and thus could not pass holder-in-due-course status, or good title, to someone in the position of the defendant.

This conclusion, however, is not without doubt. For instance, in 2 Anderson, Uniform Commercial Code § 3-202:35 (2nd ed.1971), it was observed that:

*The Code states that bearer paper is negotiated by “delivery.” This is likely to mislead for one is not inclined to think of the acquisition of paper by a finder or a thief as a “voluntary transfer of possession.”*

By stating that the Code’s terminology was “misleading,” the treatise appears to imply that despite the literal import of the words, the contrary was true—negotiation could be accomplished by involuntary transfer, *i.e.*, loss or theft.

In [Citation], the Appellate Division determined that the Tropicana Casino in New Jersey became a holder in due course of signed cashier’s checks with blank payee designations which a thief had stolen from the defendant and negotiated to the casino for value after filling in the payee designation with his brother-in-law’s name. The Appellate Division, assuming without discussion that the thief was a “holder” of the stolen instruments and therefore able to transfer good title, held the defendant obligated to make payment on the stolen checks. Accord[Citation] (check cashing service which unknowingly took for value from an intervening thief the plaintiff’s check, which the plaintiff had endorsed in blank and thus converted to a bearer instrument, was a holder in due course of the check, having received good title from the thief).

Presumably, these results have occurred because the courts in New York have implicitly interpreted the undefined term “transfer” as utilized in [the pre-1990] U.C.C. § 3-202(1) as including the involuntary transfer of possession, so that as a practical matter the old Code (as still in effect in New York) has the same meaning as the new Model Uniform Commercial Code, which represents a clarification rather than a change in the law.

This result makes sense. A contrary result would require extensive verification procedures to be undertaken by all transferees of bearer paper. The problem with imposing an identity or ownership check
requirement on the negotiation of bearer paper is that such a requirement would impede the free
negotiability which is the essence of bearer paper. As held in [Citation (1970)],

*Where* the instrument entrusted to a dishonest messenger or agent was freely negotiable bearer
paper...the drawee bank [cannot] be held liable for making payment to one presenting a
negotiable instrument in bearer form who may properly be presumed to be a holder [citations
omitted].

...Moreover, the plaintiff in the instant case knew that the voucher could be “Exchange[d] for cash.” The
plaintiff conceded at trial that (1) when he himself utilized the voucher prior to its loss, no identity or
ownership check was ever made; and (2) he nevertheless continued to use it. The plaintiff could therefore
not contend that he had any expectation that the defendant had in place any safeguards against the
voucher’s unencumbered use, or that he had taken any actions in reliance on the same.

This Court is compelled to render judgment denying the plaintiff’s claim, and in favor of the defendant.

**CASE QUESTIONS**

1. Was the instrument in question a note or a draft?
2. How did the court determine it was bearer paper?
3. What would the racetrack have to have done if it wanted the machine to dispense order paper?
4. What confusion arose from the UCC’s pre-1990 use of the words “transfer” and “delivery,” which was
   clarified by the revised Article 3’s use of the phrase “transfer of possession”? Does this offer any insight
   into why the change was made?
5. How had—the New York courts decided the question as to whether a thief could be a holder when
   the instrument was acquired from its previous owner involuntarily?

**Joint Payees and Conditional and Restrictive Indorsements**

*Wisner Elevator Company, Inc. v. Richland State Bank*

*862 So.2d 1112 (La. App. 2003)*

Gaskins, J.
Wisner Elevator Company, Inc. [plaintiff] ("Wisner"), appeals from a summary judgment in favor of the defendant, Richland State Bank. At issue is the deposit of a check with a typed statement on the back directing that a portion of the funds be paid to a third party. We affirm the trial court judgment.

**Facts**

On July 13, 2001, the United States Treasury, through the Farm Service Agency, issued a check in the amount of $17,420.00, made payable to Chad E. Gill. On the back of the check the following was typed:

- PAY TO THE ORDER OF RICHLAND STATE BANK FOR ISSUANCE OF A CASHIER'S CHECK
- PAYABLE TO WISNER ELEVATOR IN THE AMOUNT OF $13,200.50 AND PAY THE BALANCE
- TO CHAD GILL IN THE AMOUNT OF $4,219.50.

On July 23, 2001, the check was deposited into Gill’s checking account at Richland State Bank. Gill’s signature is found on the back of the check below the typed paragraph. No cashier check to Wisner Elevator was issued; instead the entire amount was deposited into Gill’s checking account as per Gill’s deposit ticket.

...On May 28, 2002, Wisner filed suit against the bank, claiming that its failure to apply the funds as per the restrictive indorsement constituted a conversion of the portion of the check due to Wisner under UCC 3-206(c)(2) [that a depositary bank converts an instrument if it pays out on an indorsement “indicating a purpose of having the instrument collected for the indorser or for a particular account”].

[The bank] asserted that the indorsement on the back of the check was a conditional indorsement and ineffective under 3-206(b), [which states:]

- An indorsement stating a condition to the right of the indorsee to receive payment does not affect the right of the indorsee to enforce the instrument. A person paying the instrument or taking it for value or collection may disregard the condition, and the rights and liabilities of that person are not affected by whether the condition has been fulfilled.

...[T]he bank asserts the fault of the United States Treasury..., in failing to make the check payable to both Gill and Wisner. To the extent that the indorsement was conditional, the bank contends that it was unenforceable; to the extent that it was restrictive, it maintains that the restrictions were waived by the indorser when he deposited the full amount of the check into his own checking account.

Wisner...[stated that it] was owed $13,200.50 by Gill for seeds, chemicals, crop supplies and agricultural seed technology fees. [It] further stated that Gill never paid the $13,200.50 he owed and that Wisner did
not receive a cashier’s check issued in that amount by Richland State Bank....According to [the bank
teller], Gill asked to deposit the entire amount in his account. She further stated that the bank was
unaware that the indorsement was written by someone other than Gill.

...The court found that the typed indorsement placed on the check was the indorsement of the maker, not
Gill. However, when Gill signed below the indorsement, he made it his own indorsement. The court
concluded that Gill had the legal power and authority to verbally instruct that the entire proceeds be
deposited into his account. The court stated that as long as the indorsement was his own, whether it was
restrictive or conditional, Gill had the power to ignore it, strike it out or give contrary instructions. The
court further concluded that the bank acted properly when it followed the verbal instructions given by Gill
to the teller and the written instructions on his deposit slip to deposit the entire proceeds into Gill’s
account. Consequently, the court gave summary judgment in favor of the bank. Wisner appeals....

Discussion

Wisner contends that the trial court erred in holding that the bank could disregard what Wisner
characterizes as a special and restrictive indorsement on the back of the check. It claims that under UCC
3-206, the amount paid by the bank had to be “applied consistently with” the indorsement and that the
bank’s failure to comply with the indorsement made it liable to Wisner. According to Wisner, Gill was not
entitled to deposit the amount due to Wisner by virtue of his own special indorsement and the bank
converted the check under 3-420 by crediting the full amount to Gill’s account.

The bank argues that the indorsement was conditional and thus could be ignored pursuant to 3-206(b). It
also asserts that nothing on the check indicated that the indorsement was written by someone other than
Gill. Since the check was made payable to Gill, the indorsement was not necessary to his title and could be
ignored, struck out or simply waived. The bank also claims that Wisner had no ownership interest in the
check, did not receive delivery of the check, and had no claim for conversion under 3-420.

We agree with the bank that the true problem in this case is the failure of the government to issue the
check jointly to Gill and Wisner as co-payees. Had the government done so, there would be no question as
to Wisner’s entitlement to a portion of the proceeds from the check.

Although the writing on the back of the check is referred to as an indorsement, we note that, standing
alone, it does not truly conform to the definition found in 3-204(a) [which states]:
“Indorsement” means a signature, other than that of a signer as maker, drawer, or acceptor, that alone or accompanied by other words is made on an instrument for the purpose of (i) negotiating the instrument, (ii) restricting payment of the instrument, or (iii) incurring indorser’s liability on the instrument, but regardless of the intent of the signer, a signature and its accompanying words is an indorsement unless the accompanying words, terms of the instrument, place of the signature, or other circumstances unambiguously indicate that the signature was made for a purpose other than indorsement.

This paragraph was placed on the back of the check by the government as the maker or drawer of the check. Consequently, the bank argues that Gill as sole payee could waive, ignore or strike out the language.

Although the Louisiana jurisprudence contains no similar case dealing with the Uniform Commercial Code, we may look to other jurisdictions for guidance...In [Citation, a New Jersey case] (1975), the drawer of a check placed instructions on the backs of several checks...that the instruments not be deposited until a specific future date. However, the payee presented some of the checks prior to the date specified on the back. The court found that the drawer did not have the capacity to indorse the instruments; as a result the typed instructions on the backs of the checks could not be indorsements. Instead, they were “merely requests to plaintiff who may or may not comply at its own pleasure. The instructions are neither binding on plaintiff nor the subsequent holders.” In other words, the payee could ignore the instructions.

In the instant case, the payee did precisely that. Gill ignored the writing on the back of the check and instructed the teller at the defendant bank to do the same through verbal and written instructions. Wisner argues that by affixing his signature under the writing on the back of the check, Gill made it his own indorsement. Furthermore, it asserts that it was a restrictive indorsement, not a conditional one which could be disregarded pursuant to 3-206. Wisner relies upon the provisions of 3-206 for the proposition that the check had a restrictive indorsement and that the bank converted the check because it failed to apply the amount it paid consistently with the indorsement. However, Comment 3 to 3-206 states, in pertinent part:

This Article does not displace the law of waiver as it may apply to restrictive indorsements. The circumstances under which a restrictive indorsement may be waived by the person who made it is not determined by this Article.
Not all jurisdictions recognize a doctrine of waiver of restrictive indorsements. [Citing cases from various jurisdictions in which a bank customer effectively requested the bank to disregard a restrictive indorsement; some cases affirmed the concept that the restriction could be waived (disregarded), others did not.]

In two cases arising under pre-UCC law, Louisiana recognized that indorsements could be ignored or struck out. In [Citation] (1925), the Louisiana Supreme Court held that the holder of a check could erase or strike out a restrictive indorsement on a check that was not necessary to the holder’s title. In [Citation] (1967), the court stated that an erroneous indorsement could be ignored and even struck out as unnecessary to the plaintiff’s title.

Like the trial court, we find that when Gill affixed his signature under the writing on the back of the check, he made it his own indorsement. We further find that the indorsement was restrictive, not conditional. As Gill’s own restrictive indorsement, he could waive it and direct that the check, upon which he was designated as the sole payee, be deposited in his account in its entirety.

Affirmed.

**CASE QUESTIONS**

1. Notice that the check was made payable to Chad Gill—he was the named payee on the front side of the check. To avoid the problems here, if the drawer (the US government) wanted to control the uses to which the check could be put, how should it have named the payee?

2. The court held that when Gill “affixed his signature under the writing on the back of the check, he made it his own indorsement.” But why wasn’t it the indorsement of the drawer—the US government?

3. If the language on the back was considered his own conditional indorsement (the instrument was not valid unless the stated conditions were met), how could the condition be disregarded by the bank?

4. If it was his own restrictive indorsement, how could it be disregarded by the bank?

5. What recourse does Wisner have now?

6. [1] Authors’ note: Pari-mutuel betting (from the French pari mutuel, meaning mutual stake) is a betting system in which all bets of a particular type are placed together in a pool; taxes and a house take are removed, and payoff odds are calculated by sharing the pool among all winning bets.

7. [2] Authors’ note: As of 2010, New York is the sole remaining state yet to adopt the 1990 revisions to Articles 3 and 4; it entertained a bill in 2007 and 2008 that would have enacted the 1990 revisions as

### 23.5 Summary and Exercises

#### Summary

Negotiation is the transfer of an instrument in such a form that the transferee becomes a holder. There are various methods for doing so; if the procedures are not properly adhered to, the transfer is only an assignment.

An instrument payable to the order of someone must be negotiated by indorsement and delivery to the transferee. The indorsement must convey the entire instrument. An instrument payable to bearer may be negotiated simply by delivery to the transferee.

Those who sign the instrument have made a contract and are liable for its breach. Makers and acceptors are primary parties and are liable to pay the instrument. Drawers and indorsers are secondary parties and are conditionally liable. Signatories are liable under a warranty theory.

Various forms of indorsement are possible: blank or special, restrictive or unrestrictive, qualified or unqualified.

Between drawer and drawee, liability for a forged instrument—one signed without authority—usually falls on the drawee who paid it. There are, however, several exceptions to this rule: where an imposter induces the maker or drawer to issue an instrument in the name of the payee, where the instrument is made to a fictitious payee (or to a real person who is intended to have no interest in it), and where the instrument is made by an employee authorized generally to deal in such paper.

#### Exercises

1. Mal, a minor, purchased a stereo from Howard for $425 and gave Howard a negotiable note in that amount. Tanker, a thief, stole the note from Howard, indorsed Howard’s signature and sold the note to Betty. Betty then sold the note to Carl; she did not indorsed it. Carl was unable to collect on the note because Mal disaffirmed the contract. Is Betty liable to Carl on a contract or warranty theory? Why?

2. Would the result in Exercise 1 be different if Betty had given a qualified indorsement? Explain.
3. Alphonse received a check one Friday from his employer and cashed the check at his favorite tavern, using a blank indorsement. After the tavern closed that evening, the owner, in reviewing the receipts for the evening, became concerned that if the check was stolen and cashed by a thief, the loss would fall on the tavern. Is this concern justified? What can the owner of the tavern do for protection?

4. Martha owns a sporting goods store. She employs a bookkeeper, Bob, who is authorized to indorse checks received by the store and to deposit them in the store’s bank account at Second Bank. Instead of depositing all the checks, Bob cashes some of them and uses the proceeds for personal purposes. Martha sues the bank for her loss, claiming that the bank should have deposited the money in the store’s account rather than paying Bob. Is the bank liable? Explain.

5. Daniel worked as a writer in order to support himself and his wife while she earned her MBA degree. Daniel’s paychecks were important, as the couple had no other source of income. One day, Daniel drove to Old Faithful State Bank to deposit his paycheck. Standing at a counter, he indorsed the check with a blank indorsement and then proceeded to fill out a deposit slip. While he was completing the slip, a thief stole the check and cashed it. Whose loss? How could the loss be avoided?

6. You are the branch manager of a bank. A well-respected local attorney walks into the bank with a check for $100,000 that he wants to deposit in the general account his firm has at your bank. The payee on the check is an elderly widow, Hilda Jones, who received the check from the profit-sharing plan of her deceased husband, Horatio Jones. The widow indorsed the check “Pay to the order of the estate of Horatio Jones. Hilda Jones.” The attorney produces court documents showing that he is the executor of the estate. After the attorney indorses the check, you deposit the check in the attorney’s account. The attorney later withdraws the $100,000 and spends it on a pleasure trip, in violation of his duties as executor. Discuss the bank’s liability.

7. Stephanie borrows $50,000 from Ginny and gives Ginny a negotiable note in that amount. Ginny sells the note to Roe for $45,000. Ginny’s indorsement reads, “For valuable consideration, I assign all of my rights in this note to Roe. Ginny.” When Stephanie refuses to pay the note and skips town, Roe demands payment from Ginny, claiming contract liability on the basis of her signature. Ginny argues that she is not liable because the indorsement is qualified by the language she used on the note. Who is correct? Explain.

8. The state of California issued a check that read, “To Alberto Cruz and Roberta Gonzales.” Alberto endorsed it “Pay to the order of Olivia Cruz.” What rights does Olivia get in the instrument?
9.

a. Bill’s weekly paycheck was stolen by a thief. The thief indorsed Bill’s name and cashed the check at the drawee bank before Bill’s employer had time to stop payment. May the drawee bank charge this payment against the drawer’s account? Explain.

b. Would the result change in (a) if Bill had carelessly left his check where it could easily be picked up by the thief? Explain.

c. Would the result change in (a) if the bank had specific regulations that tellers were not to cash any check without examining the identification of the person asking for cash?

d. Would the result change if Bill’s employer had carelessly left the check where it could be found by the thief?