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Chapter 19

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.

19.1 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.

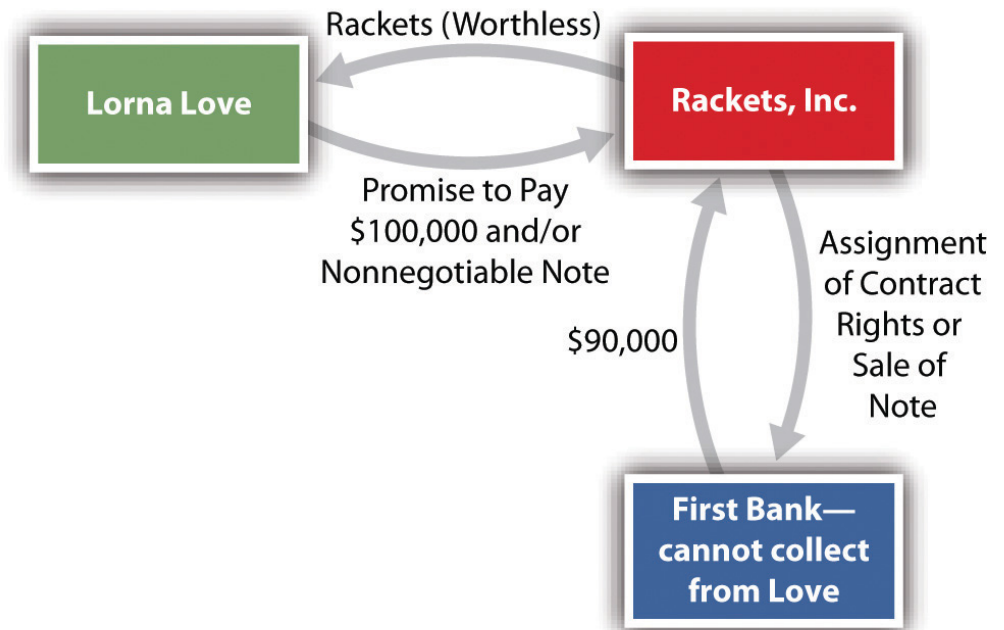
The Central Role of Commercial Paper

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 19.1 "Assignment of Contract Rights"](#)). Unfortunately, the rackets that arrive at Love's are warped and thus commercially worthless. Rackets files for bankruptcy.

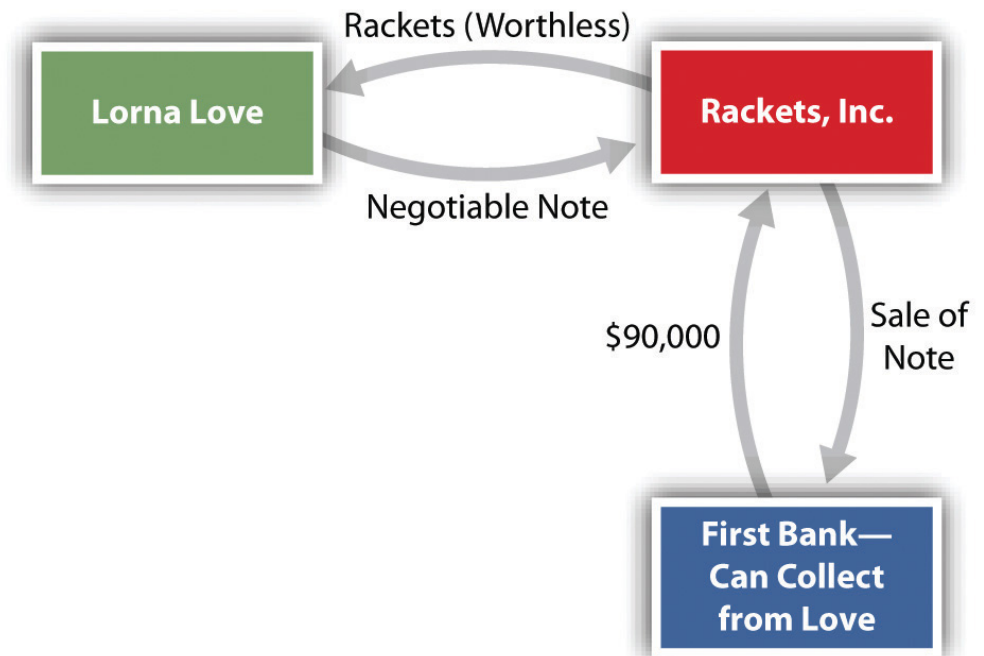
Figure 19.1 Assignment of Contract Rights



May the bank collect from Love \$100,000, the value of the contract rights it purchased? No. Under the “shoe rule” 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 19.3 "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 19.2 "Sale of Negotiable Note"](#)).

Figure 19.2 Sale of Negotiable Note



The key to the central role that commercial paper plays in modern finance is **negotiability**¹. *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. Transferable from one person to another by delivery or by delivery and indorsement.

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 20 "Negotiation of Commercial Paper"](#).
3. Is the purchaser of the paper a holder in due course? See [Chapter 21 "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 21 "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 22 "Liability and Discharge"](#).

Finally, in [Chapter 23 "Legal Aspects of Banking"](#) we examine other legal aspects of banking, including letters of credit and electronic funds transfer.

History of Commercial Paper

Development of the Law

Negotiable instruments are no modern invention; we know that merchants used them as long ago as the age of Hammurabi, around 1700 BC. They fell into disuse after the collapse of the Roman Empire and then reappeared in Italy around the fourteenth century. They became more common as long-distance commerce spread. In an era before paper currency, payment in coins or bullion was awkward, especially for merchants who traveled great distances across national boundaries to attend the fairs at which most economic exchanges took place. Merchants and traders found it far more efficient to pay with paper.

Bills of exchange, today commonly known as *drafts*, were recognized instruments in the law merchant. (The “law merchant” was the system of rules and customs recognized and adopted by early-modern traders and is the basis of the UCC Article 3.) A draft is an unconditional order by one person (the drawer) directing another person (drawee or payor) to pay money to a named third person or to bearer; a check is the most familiar type of draft. The international merchant courts regularly enforced drafts and permitted them to be transferred to others by indorsement (the legal spelling of *endorsement*). By the beginning of the sixteenth century, the British common-law courts began to hear cases involving bills of exchange, but it took a half century before the courts became comfortable with them and accepted them as crucial to the growing economy.

Courts were also hesitant until the end of the seventeenth century about sanctioning a transferor’s assignment of a promissory note if it meant that the

transferee would have better title than the transferor. One reason for the courts' reluctance to sanction assignments stemmed from the law that permitted debtors to be jailed, a law that was not repealed until 1870. The buyer of goods might have been willing originally to give a promissory note because he knew that a particular seller would not attempt to jail him for default, but who could be sure that a transferee, probably a complete stranger, would be so charitable?

The inability to negotiate promissory notes prevented a banking system from fully developing. During the English Civil War in the seventeenth century, merchants began to deposit cash with the goldsmiths, who lent it out at interest and issued the depositors promissory notes, the forerunner of bank notes. But a judicial decision in 1703 declared that promissory notes were not negotiable, whether they were made payable to the order of a specific person or to the bearer. Parliament responded the following year with the Promissory Notes Act, which for the first time permitted an assignee to sue the note's maker.

Thereafter the courts in both England and the United States began to shape the modern law of negotiable instruments. By the late nineteenth century, Parliament had codified the law of negotiable instruments in England. Codification came later in the United States. In 1896, the National Conference of Commissioners on Uniform State Laws proposed the Negotiable Instruments Act, which was adopted in all states by 1924. That law eventually was superseded by the adoption of Articles 3 and 4 of the Uniform Commercial Code (UCC), which we study in these chapters.

In 1990, the American Law Institute and the National Conference of Commissioners on Uniform State Laws approved revised Article 3, entitled "Negotiable Instruments," and related amendments in Article 4. The revisions clarified and updated the law. All states except New York and North Carolina have adopted Articles 3 and 4.

The Future of Commercial Paper: Federal and International Preemption

State law governing commercial paper is vulnerable to federal preemption. This preemption could take two major forms. First, the Federal Reserve Board governs the activities of Federal Reserve Banks. As a result, Federal Reserve regulations provide important guidelines for the check collection process. Second, Article 3 of the UCC can be preempted by federal statutes. An important example is the Expedited Funds Availability Act, which became effective in 1988 (discussed in [Chapter 23 "Legal Aspects of Banking"](#)).

Federal preemption may also become intertwined with international law. In 1988, the United Nations General Assembly adopted the Convention on International Bills

of Exchange and International Promissory Notes. Progress on the treaty emanating from the convention has been slow, however: the United States, Canada, and Russia have approved the convention (in 1989 and 1990) but have not ratified the treaty; Gabon, Guinea, Honduras, Liberia, and Mexico are the only countries to have ratified it.

Commercial Paper in Economics and Finance

Economics

To the economist, one type of commercial paper—the bank check—is the primary component of M1, the basic money supply. It is easy to see why. When you deposit cash in a checking account, you may either withdraw the currency—coins and bills—or draw on the account by writing out a check. If you write a check to “cash,” withdraw currency, and pay a creditor, there has been no change in the money supply. But if you pay your creditor by check, the quantity of money has increased: the cash you deposited remains available, and your creditor deposits the check to his own account as though it were cash. (A more broadly defined money supply, M2, includes savings deposits at commercial banks.)

Finance

Commercial paper is defined more narrowly in finance than in law. To the corporate treasurer and other financiers, commercial paper ordinarily means short-term promissory notes sold by finance companies and large corporations for a fixed rate of interest. Maturity dates range from a low of three days to a high of nine months. It is an easy way for issuers to raise short-term money quickly. And although short-term notes are unsecured, historically they have been almost as safe as obligations of the US government. By contrast, for legal purposes, commercial paper includes long-term notes (which are often secured), drafts, checks, and certificates of deposit.

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?

19.2 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**² 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**³ 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

2. A document ordering the payment of money; drawn by one person or bank on another.
3. The person who makes out (draws) a check or draft.

draft—ordering the drawee to remit a stated sum of money to the payee. The **drawee**⁴ 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**⁵: 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. *Norton v. Knapp*, 19 N.W. 867 (IA 1884).

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**⁶ calls for payment “on sight,” that is, when presented. Recall from [Section 19.1 "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**⁷, 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

4. The person (or bank) expected to pay a check or draft when it is presented for payment.

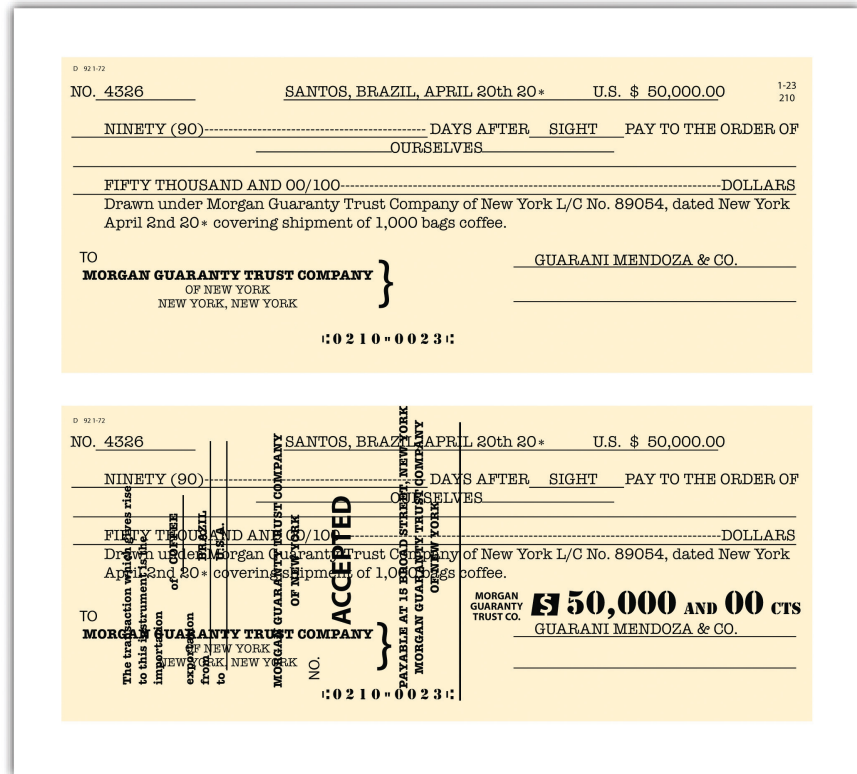
5. A drawee who accepts a draft, agreeing to be primarily responsible for paying it.

6. A draft or bill that is payable on demand or upon presentation. Also called demand draft.

7. Draft (bill of exchange) payable to a third party on a specified or determinable future date.

gets its money right away; the bank may collect from Love on the date specified. See the example of a time draft in [Figure 19.3 "A Time Draft"](#).

Figure 19.3 A Time Draft



Drafts in International Trade

Drafts are an international convention. In England and the British Commonwealth, drafts are called bills of exchange. Like a draft, a **bill of exchange**⁸ is a kind of check or promissory note without interest. Used primarily in international trade, it is a written order by one person to pay another a specific sum on a specific date sometime in the future. If the bill of exchange is drawn on a bank, it is called a bank draft. If it is drawn on another party, it is called a trade draft. Sometimes a bill of exchange will simply be called a draft, but whereas a draft is always negotiable (transferable by endorsement), this is not necessarily true of a bill of exchange.

- 8. A written order by one person to pay a sum of money to a third person.
- 9. A draft or bill of exchange accepted by a bank where the accepting institution guarantees payment. Used extensively in foreign trade transactions.

A widely used draft in international trade is the **banker's acceptance**⁹. It is a short-term credit investment created by a nonfinancial firm and guaranteed by a bank. This instrument is used when an exporter agrees to extend credit to an importer.

Assume Love, the importer, is in New York; Rackets, the exporter, is in Taiwan. Rackets is willing to permit Love to pay ninety days after shipment. Love makes a deal with her New York bank to issue Rackets' bank in Taiwan a letter of credit. This tells the seller's bank that the buyer's bank is willing to accept a draft drawn on the buyer in accordance with terms spelled out in the letter of credit. Love's bank may insist on a security interest in the tennis rackets, or it may conclude that Love is creditworthy. On receipt of the letter of credit, Rackets presents its bank in Taiwan with a draft drawn on Love's bank. That bank antes up the purchase amount (less its fees and interest), paying Rackets directly. It then forwards the draft, bill of lading, and other papers to a correspondent bank in New York, which in turn presents it to Love's bank. If the papers are in order, Love's bank will "accept" the draft (sign it). The signed draft is the banker's acceptance (see [Figure 19.3 "A Time Draft"](#)). It is returned to the bank in Taiwan, which can then discount the banker's acceptance if it wishes payment immediately or else wait the ninety days to present it to the New York bank for payment. After remitting to the Taiwanese bank, the New York bank then demands payment from Love.

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**¹⁰ as "a draft drawn on a bank and payable on demand." **Postdating**¹¹ 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**¹²; 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**¹³ 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.

10. A negotiable instrument drawn against deposited funds to pay a specified amount of money to a specific person upon demand.

11. Putting a date on an instrument (e.g., a check) that is later than the actual date.

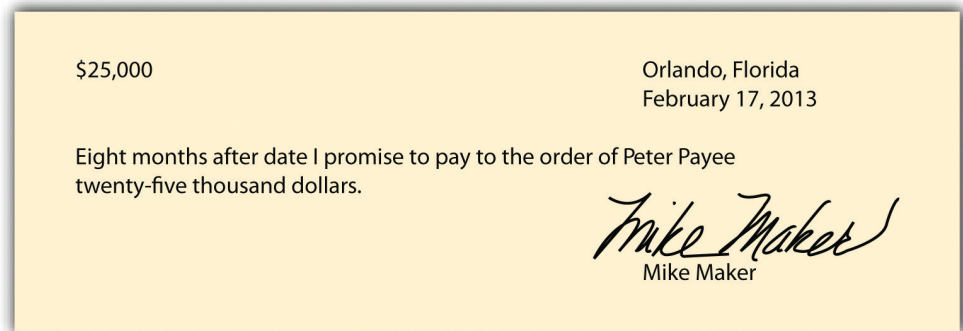
12. The acceptance by a drawee of a check or draft.

13. A check guaranteed by a bank and so as good as cash.

Notes

A note—often called a **promissory note**¹⁴—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**¹⁵ (promisor), and the **payee**¹⁶ (promisee). For an example of a promissory note, see [Figure 19.4 "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 19.4 A Promissory Note



Certificates of Deposit

A fourth type of commercial paper is the **certificate of deposit**¹⁷, 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**¹⁸ (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

14. A written promise to pay or repay a specified sum of money at a stated time or on demand.

15. A party that signs a promissory note.

16. The person who is to receive payment on a draft or note.

17. A debt instrument issued by a bank; usually pays interest.

18. The person who indorses.

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**¹⁹ 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**²⁰ 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." Uniform Commercial Code, Section 1-201(21). *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**²¹ 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 21 "Holder in Due Course and Defenses"](#).

Accommodation Party

An **accommodation party**²² 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 ([Chapter 23 "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.

19. The person to whom a note or bill is indorsed, or assigned by indorsement.

20. One who has legal possession of a draft, note, or other negotiable instrument and who is entitled to payment.

21. Good-faith holder who has taken a negotiable instrument for value, without notice that it was overdue or had been dishonored or that there was any defense against or claim to it.

22. One who signs an instrument as drawer, indorser, or acceptor to help another raise money.

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?

19.3 Requirements for Negotiability

LEARNING OBJECTIVE

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. Uniform Commercial Code, Section 1-201(39). 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 22 "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 19.4 "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. Uniform Commercial Code, Section 3-112(b). 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 19.4 "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. Uniform Commercial Code, Section 3-113(b). 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. Uniform Commercial Code, Section 3-115. See the case presented in Section 19.4 "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.’” Uniform Commercial Code, Section 3-104(d); Uniform Commercial Code, Section 3-104(f).

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?

19.4 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

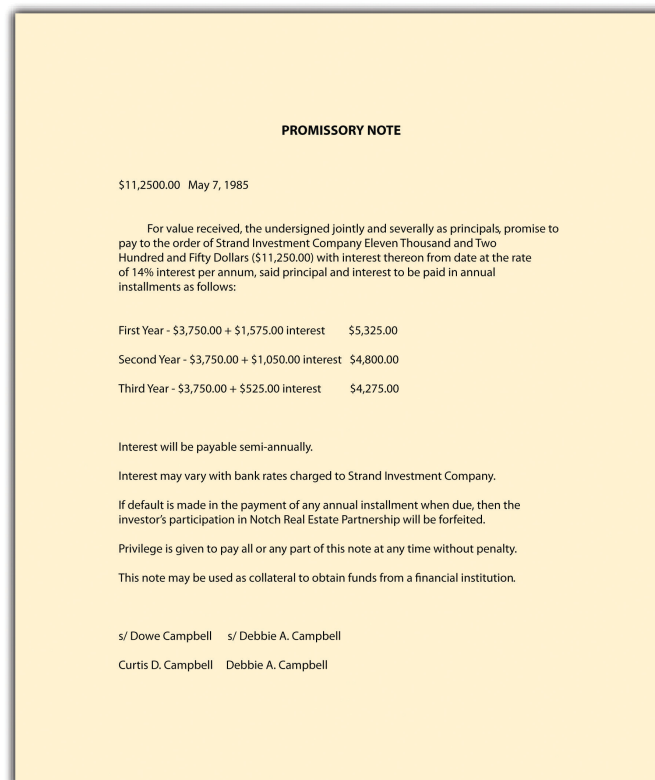
Centerre Bank of Branson v. Campbell

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

Crow, J.

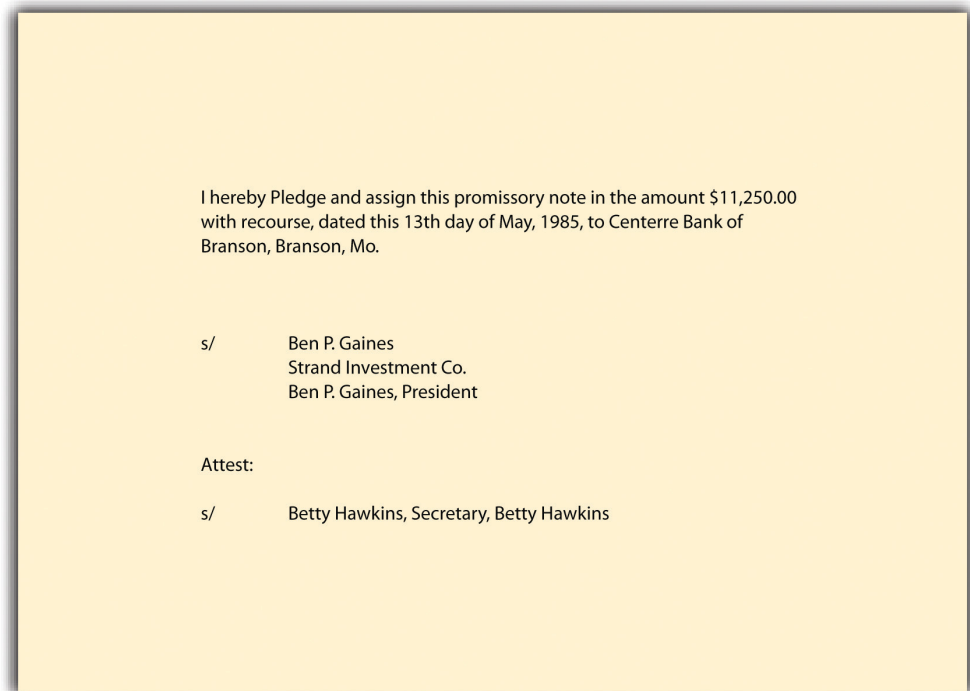
On or about May 7, 1985, appellants (“the Campbells”) signed the following document:

Figure 19.5



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 19.5] document:

Figure 19.6



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:

[T]ypewritten 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?

19.5 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.

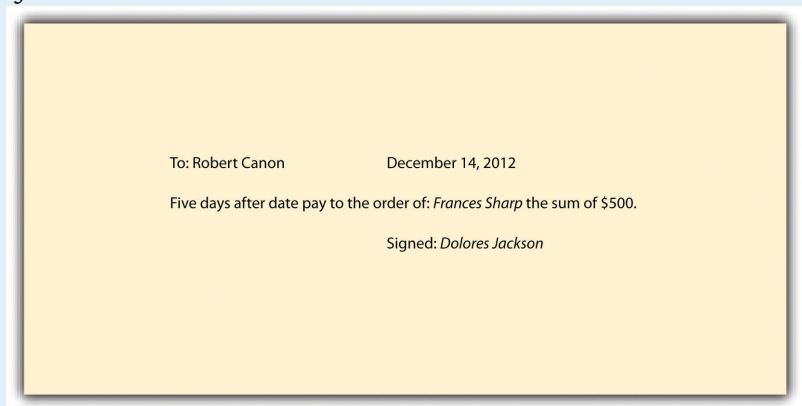
In addition to drawers, makers, drawees, and payees, one can deal with commercial paper in five other capacities: as indorsers, indorsees, holders, holders in due course, and accommodation parties.

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 19.7



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”
6. 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.
 7. 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.
 8. 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. Joel Schwarz, “Taking Things for Granite,” *Student Lawyer*, December 1981.
 9. 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.

10. 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.

SELF-TEST QUESTIONS

1. A negotiable instrument must
 - a. be signed by the payee
 - b. contain a promise to pay, which may be conditional
 - c. include a sum certain
 - d. be written on paper or electronically

2. The law governing negotiability is found in
 - a. Article 3 of the UCC
 - b. Article 9 of the UCC
 - c. the Uniform Negotiability Act
 - d. state common law

3. A sight draft
 - a. calls for payment on a certain date
 - b. calls for payment when presented
 - c. is not negotiable
 - d. is the same as a certificate of deposit

4. A note reads, “Interest hereon is 2% above the prime rate as determined by First National Bank in New York City.” Under the UCC,
 - a. the interest rate provision is not a “sum certain” so negotiability is destroyed
 - b. the note is not negotiable because the holder must look to some extrinsic source to determine the interest rate
 - c. the note isn’t negotiable because the prime rate can vary before the note comes due
 - d. variable interest rates are OK

5. A “maker” in negotiable instrument law does what?
 - a. writes a check
 - b. becomes obligated to pay on a draft
 - c. is the primary obligor on a note

d. buys commercial paper of dubious value for collection

SELF-TEST ANSWERS

1. c
2. a
3. b
4. d
5. c