Negotiable Instrument

A **negotiable instrument** is a document guaranteeing the payment of a specific amount of money, either on demand, or at a set time with the payer named on the negotiable instrument. More specifically, it is a document contemplated by a contract, which warrants the payment of money without condition which may be paid on demand or at a future date.

Examples of negotiable instruments include promissory notes, bills of exchange, banknotes and cheques.

Because money is promised to be paid, the instrument itself can be used by the holder in due course as a store of value. The instrument may be transferred to a third party; it is the holder of the instrument who will ultimately get paid by the payer on the instrument. Transfers can happen at less than the face value of the instrument and this is known as *discounting*, this may happen for example if there is doubt about the payer's ability to pay.

Due to the nature of the negotiable instrument as store of value, most countries passed laws specifically related to negotiable instruments.

**History**

Common prototypes of bills of exchanges and promissory notes originated in China. Here, in the 8th century during the reign of the Tang Dynasty they used special instruments called *feitsyan* for the safe transfer of money over long distances.¹

Later such document for money transfer used by Arab merchants, who had used the prototypes of bills of exchange – suftadja and hawala in 10–13th centuries, then such prototypes had been used by Italian merchants in the 12th century. In Italy in the 13–15th centuries, bills of exchange and promissory notes obtain their main features, while further phases of their development have been associated with France (16–18th centuries, where the endorsement had appeared) and Germany (19th century, formalization of Exchange Law). In England (and later in the U.S.), exchange law was different from continental Europe because of different legal systems.²

The modern emphasis on negotiability may also be traced to Lord Mansfield.³ Germanic Lombards documents may also have some elements of negotiability.⁴

**Negotiable instruments distinguished from other types of contracts**

A negotiable instrument can serve to convey value constituting at least part of the performance of a contract, albeit perhaps not obvious in contract formation, in terms inherent in and arising from the requisite offer and acceptance and conveyance of consideration. The underlying contract contemplates the right to hold the instrument as, and to negotiate the instrument to, a *holder in due course*, the payment on which is at least part of the performance of the contract to
which the negotiable instrument is linked. The instrument, memorializing (1) the power to
demand payment; and, (2) the right to be paid, can move, for example, in the instance of a 'bearer
instrument', wherein the possession of the document itself attributes and ascribes the right to
payment. Certain exceptions exist, such as instances of loss or theft of the instrument, wherein
the possessor of the note may be a holder, but not necessarily a holder in due course. Negotiation
requires a valid endorsement of the negotiable instrument. The consideration constituted by a
negotiable instrument is cognizable as the value given up to acquire it (benefit) and the
consequent loss of value (detriment) to the prior holder; thus, no separate consideration is
required to support an accompanying contract assignment. The instrument itself is understood as
memorializing the right for, and power to demand, payment, and an obligation for payment
evidenced by the instrument itself with possession as a holder in due course being the touchstone
for the right to, and power to demand, payment. In some instances, the negotiable instrument can
serve as the writing memorializing a contract, thus satisfying any applicable Statute of Frauds as
to that contract.

The holder in due course

The rights of a holder in due course of a negotiable instrument are qualitatively, as matters of
law, superior to those provided by ordinary species of contracts:

- The rights to payment are not subject to set-off, and do not rely on the validity of the
  underlying contract giving rise to the debt (for example if a cheque was drawn for
  payment for goods delivered but defective, the drawer is still liable on the cheque)
- No notice need be given to any party liable on the instrument for transfer of the rights
  under the instrument by negotiation. However, payment by the party liable to the person
  previously entitled to enforce the instrument "counts" as payment on the note until
  adequate notice has been received by the liable party that a different party is to receive
  payments from then on. [U.C.C. §3-602(b)]
- Transfer free of equities—the holder in due course can hold better title than the party he
  obtains it from (as in the instance of negotiation of the instrument from a mere holder to a
  holder in due course)

Negotiation often enables the transferee to become the party to the contract through a contract
assignment (provided for explicitly or by operation of law) and to enforce the contract in the
transferee-assignee’s own name. Negotiation can be effected by endorsement and delivery (order
instruments), or by delivery alone (bearer instruments).

Classes

Promissory notes and bills of exchange are two primary types of negotiable instruments.

Promissory note

Although possibly non-negotiable, a promissory note may be a negotiable instrument if it is an
unconditional promise in writing made by one person to another, signed by the maker, engaging
to pay on demand to the payee, or at fixed or determinable future time, certain in money, to order
Bank note is frequently referred to as a promissory note, a promissory note made by a bank and payable to bearer on demand.

**Introduction of bill of exchange**

A bill of exchange or "draft" is a written order by the *drawer* to the *drawee* to pay money to the *payee*. A common type of bill of exchange is the cheque (*check* in American English), defined as a bill of exchange drawn on a banker and payable on demand. Bills of exchange are used primarily in international trade, and are written orders by one person to his bank to pay the bearer a specific sum on a specific date. Prior to the advent of paper currency, bills of exchange were a common means of exchange. They are not used as often today.

![Bill of exchange, 1933](image)

A bill of exchange is essentially an order made by one person to another to pay money to a third person. A bill of exchange requires in its inception three parties—the drawer, the drawee, and the payee. The person who draws the bill is called the drawer. He gives the order to pay money to the third party. The party upon whom the bill is drawn is called the drawee. He is the person to whom the bill is addressed and who is ordered to pay. He becomes an acceptor when he indicates his willingness to pay the bill. The party in whose favor the bill is drawn or is payable is called the payee. The parties need not all be distinct persons. Thus, the drawer may draw on himself payable to his own order. A bill of exchange may be endorsed by the payee in favour of a third party, who may in turn endorse it to a fourth, and so on indefinitely. The "holder in due course" may claim the amount of the bill against the drawee and all previous endorsers, regardless of any counterclaims that may have disabled the previous payee or endorser from doing so. This is what is meant by saying that a bill is negotiable. In some cases a bill is marked "not negotiable" – see crossing of cheques. In that case it can still be transferred to a third party, but the third party can have no better right than the transferor.

**Definition**


1. defines a bill of exchange as: 'an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to
2. defines a cheque as: 'a bill of exchange drawn on a banker payable on demand'
3. defines a promissory note as: 'an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand, or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person or to bearer.'

Additionally most commonwealth jurisdictions have separate Cheques Acts providing for additional protections for bankers collecting unendorsed or irregularly endorsed cheques, providing that cheques that are crossed and marked 'not negotiable' or similar are not transferable, and providing for electronic presentation of cheques in inter-bank cheque clearing systems. The 1911 Encyclopædia Britannica Eleventh Edition has a comprehensive article on the Bill of Exchange, detailing its history and operation, as understood at the time of its publication.

**In the United States**

In the United States, Article 3 and Article 4 of the Uniform Commercial Code govern the issuance and transfer of negotiable instruments. The various State law enactments of Uniform Commercial Code §§3-104(a) through (d) set forth the legal definition of what is and what is not a negotiable instrument:

§ 3-104. NEGOTIABLE INSTRUMENT.

(a) Except as provided in subsections (c) and (d), "negotiable instrument" means an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it: (1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder; (2) is payable on demand or at a definite time; and (3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, but the promise or order may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor. (b) "Instrument" means a negotiable instrument. (c) An order that meets all of the requirements of subsection (a), except paragraph (1), and otherwise falls within the definition of "check" in subsection (f) is a negotiable instrument and a check. (d) A promise or order other than a check is not an instrument if, at the time it is issued or first comes into possession of a holder, it contains a conspicuous statement, however expressed, to the effect that the promise or order is not negotiable or is not an instrument governed by this Article.

Thus, for a writing to be a negotiable instrument under Article 3,[6] the following requirements must be met:
1. The promise or order to pay must be unconditional;
2. The payment must be a specific sum of money, although interest may be added to the sum;
3. The payment must be made on demand or at a definite time;
4. The instrument must not require the person promising payment to perform any act other than paying the money specified;
5. The instrument must be payable to bearer or to order.

The latter requirement is referred to as the "words of negotiability": a writing which does not contain the words "to the order of" (within the four corners of the instrument or in endorsement on the note or in allonge) or indicate that it is payable to the individual holding the contract document (analogous to the holder in due course) is not a negotiable instrument and is not governed by Article 3, even if it appears to have all of the other features of negotiability. The only exception is that if an instrument meets the definition of a cheque (a bill of exchange payable on demand and drawn on a bank) and is not payable to order (i.e. if it just reads "pay John Doe") then it is treated as a negotiable instrument.

**Negotiation and endorsement**

Persons other than the original obligor and obligee can become parties to a negotiable instrument. The most common manner in which this is done is by placing one's signature on the instrument ("endorsement"): if the person who signs does so with the intention of obtaining payment of the instrument or acquiring or transferring rights to the instrument, the signature is called an endorsement. There are five types of endorsements contemplated by the Code, covered in UCC Article 3, Sections 204–206:

- An endorsement which purports to transfer the instrument to a specified person is a **special endorsement** – for example, "Pay to the order of Amy";
- An endorsement by the payee or holder which does not contain any additional notation (thus purporting to make the instrument payable to bearer) is an **endorsement in blank** or **blank endorsement**;
- An endorsement which purports to require that the funds be applied in a certain manner (e.g. "for deposit only", "for collection") is a **restrictive endorsement**; and,
- An endorsement purporting to disclaim retroactive liability is called a **qualified endorsement** (through the inscription of the words "without recourse" as part of the endorsement on the instrument or in allonge to the instrument).
- An endorsement purporting to add terms and conditions is called a **conditional endorsement** – for example, "Pay to the order of Amy, if she rakes my lawn next Thursday November 11th, 2007". The UCC states that these conditions may be disregarded.\(^\text{[7]}\)

If a note or draft is negotiated to a person who acquires the instrument

1. in good faith;
2. for value;
3. without notice of any defenses to payment,
the transferee is a **holder in due course** and can enforce the instrument *without* being subject to defenses which the maker of the instrument would be able to assert against the original payee, except for certain *real defenses*. These real defenses include (1) forgery of the instrument; (2) fraud as to the nature of the instrument being signed; (3) alteration of the instrument; (4) incapacity of the signer to contract; (5) infancy of the signer; (6) duress; (7) discharge in bankruptcy; and, (8) the running of a statute of limitations as to the validity of the instrument. The **holder-in-due-course rule** is a *rebuttable presumption* that makes the free transfer of negotiable instruments feasible in the modern economy. A person or entity purchasing an instrument in the ordinary course of business can reasonably expect that it will be paid when presented to, and not subject to dishonor by, the maker, without involving itself in a dispute between the maker and the person to whom the instrument was first issued (this can be contrasted to the lesser rights and obligations accruing to mere holders). Article 3 of the Uniform Commercial Code as enacted in a particular State's law contemplate *real defenses* available to purported holders in due course. The foregoing is the theory and application presuming compliance with the relevant law. Practically, the obligor-payor on an instrument who feels he has been defrauded or otherwise unfairly dealt with by the payee may nonetheless refuse to pay even a holder in due course, requiring the latter to resort to litigation to recover on the instrument.

**Usage**

While bearer instruments are rarely created as such, a holder of commercial paper with the holder designated as payee can change the instrument to a bearer instrument by an endorsement. The proper holder simply signs the back of the instrument and the instrument becomes bearer paper, although in recent years, third party checks are not being honored by most banks unless the original payee has signed a notarized document stating such. Alternatively, an individual or company may write a check payable to "Cash" or "Bearer" and create a bearer instrument. Great care should be taken with the security of the instrument, as it is legally almost as good as cash.

**Exceptions**

Under the Code, the following are not negotiable instruments, although the law governing obligations with respect to such items may be similar to or derived from the law applicable to negotiable instruments:

- Bills of lading and other documents of title, which are governed by Article 7 of the Code. However, under admiralty law, a bill of lading may either be a negotiable or 'order' bill of lading or a nonnegotiable or 'straight' bill of lading.
- Deeds and other documents conveying interests in real estate, although a mortgage may secure a promissory note which is governed by Article 3
- IOUs
- Letters of credit, which are governed by Article 5 of the Code

**Modern relevance**
Although often considered foundational in business law, the modern relevance of negotiability has been questioned.[8] Negotiability can be traced back to the 1700s and Lord Mansfield, when money and liquidity was relatively scarce.[3] The holder in due course rule has been limited by various statutes.[3] Concerns have also been raised that the holder in due course rule does not align the incentives of the mortgage originators and the assignees efficiently.[3]

References

2. s:1911 Encyclopedia Britannica/Bill of Exchange
5. CONFUSING
6. Uniform Commercial Code - Article 3
7. Article 3, Sections 206(b)

Source: http://en.wikipedia.org/wiki/Negotiable_instrument
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